S. HRG. 99-758

DEPARTMENT OF DEFENSE EXPENDITURE RATE AND OUTLAY MANAGEMENT CONTROL

HEARING

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

SPECIAL HEARING

CONGRESSIONAL BUDGET OFFICE
DEPARTMENT OF DEFENSE

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CONTENTS

CONGRESSIONAL BUDGET OFFICE

	Page
Statement of Rudolph G. Penner	1
Opening remarks of Senator Proxmire	2
Prepared statement of Senator D'Amato	4
Table: Comparison of Fiscal Year 1987 Defense Outlay Estimates	6
Table: Comparison of Fiscal Year 1986 Defense Outlay Projections	7
Prepared statement of Rudolph G. Penner	10
Additional committee questions	21

DEPARTMENT OF DEFENSE

Statement of William H. Taft, IV, Deputy Secretary of Defense	29
Prepared statement	33
Letter from Rudolph G. Penner	59
Additional committee questions	63

DEPARTMENT OF DEFENSE EXPENDITURE RATE AND OUTLAY MANAGEMENT CONTROL

THURSDAY, AUGUST 7, 1986

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
SUBCOMMITTEE ON DEFENSE,
Washington, DC.

The subcommittee met at 10 a.m., in room SD–138, Dirksen Senate Office Building, Hon. Ted Stevens (chairman) presiding.

Present: Senators Stevens, D'Amato, Rudman, Proxmire, and Chiles.

CONGRESSIONAL BUDGET OFFICE

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

OPENING STATEMENTS OF SUBCOMMITTEE MEMBERS

DEFENSE BUDGET AUTHORITY REQUEST

Senator STEVENS. Good morning.

We are here today to discuss defense expenditure rates, and other related matters. This year more than ever before, the matter of defense outlays is of paramount importance.

The fiscal year 1987 defense budget request got off to a rocky start with the Congressional Budget Office and the Office of Management and Budget disagreeing over expenditure levels associated with the defense function. Things did not improve with the budget resolution which created a mismatch between the budget authority approved and the outlay targets allotted to the budget authority.

It is now apparent CBO's estimate was more accurate than OMB's. Yesterday OMB released its midsession review. To reflect the budget resolution, the defense budget authority request was reduced by $23.1 billion, but the outlay estimate has only been reduced $100 million.

BUDGET CHANGES AS RESULT OF GRH

In past years an unreasonable outlay figure or disagreement between the two scorekeepers might not have been a serious impediment to formulation of a Defense appropriation bill. The adoption of Public Law 99--177, the so-called Gramm-Rudman-Hollings legislation has changed all that.

Under GRH, the estimates of outlays by CBO as interpreted by the Budget Committee may not exceed the targets established in the budget resolution. As such, with an unrealistic outlay target, the Senate Appropriations Committee finds itself in a difficult situation because of the unrealistic outlay target and we must comply with that outlay target despite the fact that we are also expected to meet the budget authority ceiling.

CHANGES IN OUTLAY POLICY

Now, I asked to hold this hearing today to get some professional advice on outlays and to see if there is something we might do. We need the current status, expectations for the future and we need to explore the policy options which might give us some control of the situation.

Unless we change the outlay policy, I think we have only two options, both of them unattractive.

The first is to appropriate less budget authority than the amount agreed upon by Congress, and that would be difficult since the resolution already cuts $28 billion from the President's request.

The second would be to make deep cuts in the fast spending, in pay and in readiness, and protect the slow spending investment accounts. That is unattractive, obviously, because of what it would do to readiness. It would only aggravate deficit problems in the future as the low spend-out authority started to outlay.

So, that is why we are here, as far as I am concerned to see if there is any way we can brunt the effect of the low outlay figure by some sort of budgetary policy changes that could be agreed upon.

We expect that we will have policy level spokesmen from the Department of Defense—Dr. Penner is here now—and the Assistant Secretary of Defense (Comptroller) Helm. We know you are very familiar with the problem we face.

I just figure it would be best to have it on the record and have what I hope will be a searching for a solution before we start rather than trying to get such a solution at midnight, at 5 o'clock in the middle of a Conference Committee on a continuing resolution, which is where I think we are going with defense this year.

Do you have any opening statement?

OPENING REMARKS OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

I would like to commend Chairman Stevens for holding today's hearing and for agreeing to include the topic of defense inflation.

The administration's midyear review of the 1987 budget underlines the importance of inflation assumptions in the defense budget and indicates its relevance to the issue of expenditure rates.

DOD INFLATION DIVIDEND

The Defense Department has realized an enormous inflation dividend over the past 5 years. The General Accounting Office estimates it as $44.5 billion, or about $9 billion per year. The Pentagon's estimate is about $7 billion per year.

There are two reasons why Congress has appropriated excess funds for defense inflation. One is that OMB's inflation assumptions, incorporated in the President's budget proposals, have been too high.

Second, the Pentagon has been allowed to add a multiplier to the OMB inflation estimate. The result is that OMB's incorrect inflation assumptions have been made even more incorrect.

REPROGRAMMING

What has happened to the excess inflation funds? Much of them have been reprogrammed for other purposes. The Pentagon claims $15.3 billion of excess inflation funds have been reprogrammed in the past 5 years.

I realize that reprogramming is not the main focus of this hearing. But it is a major problem and a flaw in the way we appropriate for defense, and I would hope that the subcommittee will soon turn its full attention to it. GAO estimates that reprogrammings totaled over $29 billion during fiscal years 1981–85.

Much of the funds reprogrammed went from procurement into R&D and one can only wonder whether the Pentagon is using reprogramming procedures to modify the priorities established by Congress. There is much to criticize about the reprogramming procedures.

REVISIONS ON INFLATION ASSUMPTIONS

Looking again at yesterday's midyear review, we see that OMB has lowered its inflation assumptions. In February, it expected inflation to be 3.8 percent in 1986. It now expects inflation to be only 2.4 percent. The 1987 figure is reduced from 4.1 percent to 3.7 percent.

How do these revisions effect the budget request for defense and possible excess inflation funds?

According to a Joint Economic Committee staff estimate made prior to yesterday's budget revision, excess inflation funds will total about $6 billion in fiscal year 1986 and about $5 billion in fiscal year 1985.

I might add that in addition to providing a windfall for defense, the overestimates of inflation also happen to lower the estimated Federal deficit. If you increase the inflation estimate by just 1 percentage point beginning 1986, you can show lower deficits totaling $58 billion over the next 5 years.

Mr. Chairman, if we are looking for ways to hold outlays down to the figure in the budget resolution, excess inflation funding offers a golden opportunity. We ought to reduce the defense request by the amount we can reasonably estimate to represent excess inflation.

A longer term solution requires legislation that would provide us with more information about the amount needed to offset inflation, controls over the expenditure of inflation funds, and a system for tracking those expenditures. I am convinced that congressional action along these lines is the only way we can avoid the mistakes of the past.

FIVE-YEAR RECORD OF INFLATION PREDICTIONS

It is true, of course, that no one can accurately predict future inflation. But the past 5 years show a pattern of mistakes in only one direction, on the high side by $7 to $9 billion annually. It is time to provide a corrective. We ought to at least have better information about the inflation request and a mechanism for recapturing unexpended funds.

Thank you, Mr. Chairman.

Senator STEVENS. Thank you.

I might say if you go back and look at the Carter administration, I made the same statement for the other side. The other side of it was at that time the Carter administration was totally underestimating inflation. We fought several times for inflationary adjustment.

What you are saying is the same thing. It is still being unable to accurately predict inflation, whether on the high side or low side. We have been given real difficulties on this subcommittee because of the inflation factor.

PREPARED STATEMENT OF SENATOR D'AMATO

Senator D'Amato has requested that his prepared remarks be placed in the record. Without objection, we will do so at this point.

[The statement follows:]

PREPARED STATEMENT OF HON. ALFONSE D'AMATO

U.S. SENATOR FROM NEW YORK

Mr. Chairman, I want to commend you for holding this hearing today on the Defense Department's expenditure rates, and I look forward to the testimony of Deputy Secretary of Defense, William Taft, Assistant Secretary of Defense, Robert Helm, and Director of the Congressional Budget Office, Rudolph Penner.

Our strategic modernization program required substantial budget authority over the past several years. Because of successful efforts in Congress to reduce budget authority for our Nation's defense in the last couple of years, defense outlay figures now are growing faster than budget authority. A discrepancy has developed over the amounts necessary for outlays in the President's Defense Department request of $320 billion for fiscal year 1987. The Pentagon states that outlays, which directly affect the deficit, will only be $282 billion; whereas the Congressional Budget Office estimates they will be $297 billion, a $15 billion discrepancy with a significant impact on the budget deficit.

The Gramm-Rudman-Hollings legislation has changed the way we estimate our budgets. Recent economic figures indicating a lower-than-expected growth in our economy will result in a reestimation of our budget deficit and an even more severe impact on our national security expenditures. I expect the defense budget, as well as our foreign aid budget, to be drastically affected in the next fiscal year.

Mr. Taft, you have outlined proposals in your statement to assure that outlays fall within the estimate. I would suggest to you as well that you consider the budget impact of windfall savings acquired from lower-than-expected inflation. In response to my request in September 1985, the GAO issued a report on the magnitude of inflation savings by the Defense Department. It was updated in March of this year. This update reveals that the estimated inflation dividend for fiscal year 1986 will be an incredible $7.5 billion. During fiscal years 1982 through 1986, the total inflation windfall was $39.5 billion.

Mr. Chairman, I realize the purpose of this hearing is to try to answer questions on the defense outlay figures. I believe that the windfall inflation problem is a symptom of the defense budget chaos in which we are mired. As one of the strongest supporters of our defense modernization, it is difficult for me to reconcile the administration's re-

quest for a large increase in defense spending for fiscal year 1987 with an inflation dividend for the military estimated this year at $7.5 billion.

Mr. Chairman, Congress is now, and this committee will soon be, anguishing over difficult defense budget decisions. Indeed, the Gramm-Rudman-Hollings budget legislation already has made sharp cuts. There will be further reductions in defense spending under the Gramm-Rudman-Hollings bill. Thus, proper accounting by the Defense Department of these inflation dividends will better ensure that essential defense programs will not be emasculated or eliminated.

Mr. Chairman, I am not surprised, however, that there is an outlay problem. The fault is not all the Pentagon's. Congress, which must authorize and appropriate money for defense, seems to be losing control over where this money goes. It is, therefore, imperative for Congress to strengthen its oversight abilities.

I would hope, Mr. Chairman, that we can and will adequately address the defense budget problems. I offer you my support on this matter.

Thank you, Mr. President.

INTRODUCTION OF RUDOLPH PENNER

Senator STEVENS. We are pleased to have you here, Dr. Penner. You are our friend and you have been of real assistance as a friend to this subcommittee. I do not see how we can mark up this bill unless we can find a way that we can encourage you and the OMB and the GAO and the Department of Defense to come closer to an agreement on what the outlay figures are associated with any particular authorization that we might be asked to fund.

We are pleased to have your statement, Dr. Penner.

TOPICS ON DEFENSE EXPENDITURE RATES

Mr. PENNER. Thank you very much, Mr. Chairman.

I am pleased to have this opportunity to discuss Department of Defense expenditure rates. My statement this morning will cover three topics: A review of our past and current estimates for defense outlays in 1987; a discussion of outlays to date; and a discussion of the practicality of managing outlays so that they hit a given target.

REVIEW OF 1987 OUTLAY ESTIMATES

Last February, for function 050—that is, national defense—the administration requested budget authority of $320 billion for fiscal year 1987 and estimated that this amount would result in outlays of $282 billion. In contrast, the Congressional Budget office [CBO] estimated that appropriations of this magnitude would result in outlays of $297 billion, or $14.5 billion higher than the amount estimated by the administration.

Our estimating differences with the administration were concentrated in three appropriation catgories: operation and maintenance [O&M]; procurement; and research, development, test, and evaluation [RDT&E]. Incidentially, CBO and the administration have never had an estimating difference of that magnitude before.

The estimating difference occurred because CBO and the administration had different assumptions about the relevance of historical spending patterns. CBO assumed that history would continue to be a reliable guide for predicting future outlays. The administation assumed that his-

tory would not be a reliable guide because of management initiatives and other factors that would tend to reduce outlays. In fact, as we showed in our "Analysis of the President's Budgetary Proposals," published last February, we had little disagreement with the administration as to what the historical rates were—only if they were still relevant.

OMB MIDSESSION REVIEW

In the Office of Management and Budget midsession review of the 1987 budget, which was released yesterday, the administration has reduced its 1987 appropriation request for national defense programs to $299 billion. Total estimated outlays remain at $282 billion, which implies an upward adjustment of at least $9 billion in the administration's outlay estimates for 1987. Based on the distribution of budget authority by appropriation account, CBO estimates that the $299 billion in new budget authority would produce total outlays of about $289 billion, or $6.7 billion more than estimated by the administration. Table 1 summarizes the estimating differences in February and August; it shows that the main areas of disagreement continue to be O&M, procurement, and RDT&E.

[Table 1 follows:]

TABLE 1: COMPARISON OF DEFENSE OUTLAY ESTIMATES FOR FISCAL YEAR 1987 (In billions of dollars)

Category	Outlays Based on Budget Authority of $320 Billion (as of February 1986)			Outlays Based on Budget Authority of $299 Billion (as of August 1986)		
	CBO	Admin.	Diff.	CBO	Admin.	Diff.
Military Personnel	73.4	73.6	-0.2	72.9	73.1	-0.2
O&M	81.6	80.9	0.7	76.7	75.1	1.6
Procurement	86.3	76.7	9.6	85.1	81.7	3.4
RDT&E	35.7	31.6	4.1	35.4	33.0	2.4
Military Construction	5.2	4.6	0.6	5.1	5.0	0.1
Family Housing	3.0	2.5	0.5	3.0	2.7	0.2
Revolving Funds	1.2	1.8	-0.6	1.0	1.6	-0.7
Other:DoD	2.3	2.6	-0.3	2.1	2.1	0.0
Subtotal:DoD	288.7	274.3	14.5	281.1	274.4	6.7
DOE	7.7	7.7	---	7.4	7.5	-0.1
Other Defense	0.3	0.3	---	0.3	0.3	0.0
Total:050	296.7	282.2	14.5	288.8	282.2	6.7

SOURCES: Congressional Budget Office and Office of Management and Budget.

OUTLAYS TO DATE FOR 1986

Mr. PENNER. Outlays for the first 9 months of 1986 are 9.5 percent greater than a year ago. If that rate of growth continues for the rest of the year, outlays will total about $277 billion compared with our February estimate of $270 billion and the administration's $266 billion. Table 2 shows that most of the unexpected growth is occurring in O&M, RDT&E, and the revolving funds.

[Table 2 follows:]

TABLE 2: COMPARISON OF DEFENSE OUTLAY PROJECTIONS FOR FISCAL YEAR 1986 (In billions of dollars)

Category	Feb. 1986 Estimates CBO	Feb. 1986 Estimates OMB	Feb. 1986 Estimates Diff.	Aug. 1986 Estimates CBO	Aug. 1986 Estimates OMB	Aug. 1986 Estimates Diff.	Actual Growth thru June (Percent)	Extrapolation
Military Personnel	71.7	71.4	0.3	71.2	71.4	-0.3	6.8	72.5
O&M	74.1	74.1	*	76.5	74.1	2.4	5.3	76.2
Procument	78.1	75.7	2.4	77.7	79.1	-1.4	11.4	78.4
RDT&E	30.3	28.7	1.6	31.8	30.0	1.8	18.6	32.2
Military Construction	5.0	4.5	0.5	5.0	4.8	0.3	17.3	5.0
Family Housing	2.6	2.4	0.2	2.6	2.6	0.1	9.6	2.9
Revolving Funds and Other-DoD	0.3	1.6	-1.4	0.7	1.4	-0.7	54.7	1.2
Subtotal	262.1	258.4	3.6	265.5	263.5	2.1	9.7	269.1[a]
DOE & Other	7.5	7.5	*	7.8	7.9	-0.2	6.2	7.6
Total 050	269.5	265.8	3.7	273.3	271.4	1.9	9.5	276.7

SOURCES: Congressional Budget Office and Office of Mangement and Budget.

a. This amount is not the sum of the preceding categories; rather, it is an extrapolation of aggregate growth based on a 9.7 percent aggregate growth rate over total 1985 outlays of $245.3 billion. The sum of the extrapolations of the first seven categories is $268.4 billion.

EFFECT OF OUTLAY ESTIMATING

Mr. PENNER. With such a high rate of growth this late in the year—we have not projected that high rate will continue—we raised our 1986 estimate by $3.8 billion to $273.3 billion. We expect the momentum of this spending surge to carry into 1987, and we raised our estimate for that year by $1.5 billion. Some data suggest that we should have raised our estimates more, but actual outlays also could be lower. Outlay estimating is an imprecise process that uses both historical data and analytic judgments. CBO's estimating goal is to find the number with equal probability of being too high as too low. The range of estimating error is likely to be around 1 to 2 percent—that is, around $3 to $5 billion.

DIFFICULTIES IN MANAGING OUTLAYS

Occasionally, there is a suggestion that the Government in general and the Defense Department, in particular, should manage its program so that outlays hit some specific target. In February, the administration argued that it could manage its outlays to achieve its defense outlay estimates through various policy changes and other measures. CBO believed that these factors could affect outlays by only a small amount, if at all. What impact they might have should be temporary and would not affect outlays beyond a few months. We discussed this at some length in our analysis of the President's budget for 1987. (See Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 1987" (February 1986), Chapter III.)

OUTLAY MANAGEMENT

We believe that managing outlays would be difficult because of the decentralized nature of the defense finance and accounting system. Managing outlays would require fundamental changes in the way thousands of programs are pursued and in the business practices of equally numerous finance officers. To make a reasonable attempt to meet an exact outlay target would require an intricate set of controls that would take a long time to develop. Certainly, one should not expect such a system to yield much more than marginal savings during 1987.

Even over the long term, a number of considerations would affect the desirability or practicality of moving toward outlay management. One such difficulty stems from the fact that about a third of all defense outlays result from prior-year appropriations and contract commitments. Controlling these outlays would be difficult because, as contractors make deliveries, they expect to be paid. In those instances where delays are legally possible, they may induce contractors to raise future contract bids, thereby raising the cost of procurement.

One way to manage outlays, however, is to slow obligations. Yet, this avenue has certain problems that stem from conflicting objectives of keeping outlays down and, at the same time, using appropriations to serve their purpose of improving national defense. Further, the ability to slow obligations is constrained by time limits on the availability of funding. After these limits are reached, unobligated funds lapse or are no longer available. To the extent that obligations were slowed, inefficiencies and cost growth might result, making the slowdown undesirable even if it were possible. Obviously, these problems would be less severe the smaller the attempted reduction in outlays.

RAND CORPORATION STUDY

A recent study by the Rand Corp. for the Air Force made many of these same points and others. (Massey, H.G., et al., "Air Force Outlay Control: Management Implications and Options," Santa Monica, CA: Rand Corp., 1985). The study concluded that moving toward outlay controls would require immediate attention to: 1) Bringing outlay planning

into the defense planning, programming, and budgeting system so that plans reflect long-term outlay concerns (to include better forecasting and tracking of outlays); 2) Identifying within the year adjustment measures and their effects so that fine tuning of outlays could be based on priorities; and 3) Establishing a central authority for implementing adjustment measures within the year.

OBSERVATIONS OF RAND STUDY

Perhaps the most important observation of the Rand study was that:

> Financial management under outlay budgeting appears to require greater budgetary discretion for the Executive Branch than is likely to be acceptable to the Congress.

In particular, the study found that authority and flexibility were critical to effective outlay control and that to provide them would require giving the executive branch greater reprogramming and impoundment authority as well as reducing full funding of procurement.

In conclusion, Mr. Chairman, while outlay estimating is difficult and inexact, CBO estimates are holding up very well. We have had to make only small adjustments to our estimates as outlays for 1986 have come in very strongly. We have not projected that the current high rate of outlay growth will continue, but we have raised our 1986 estimate by $3.8 billion.

Thank you.

[The prepared statement of Mr. Penner follows:]

PREPARED STATEMENT OF RUDOLPH G. PENNER
DIRECTOR
CONGRESSIONAL BUDGET OFFICE

Mr. Chairman and Members of the Subcommittee, I am pleased to have this opportunity to discuss Department of Defense expenditure rates. My statement this morning will cover three topics-- a review of our past and current estimates for defense outlays in 1987, a discussion of outlays to date, and a discussion of the practicality of "managing" outlays so that they hit a given target.

REVIEW OF 1987 OUTLAY ESTIMATES

Last February, for function 050 (that is, national defense) the Administration requested budget authority of $320 billion for fiscal year 1987 and estimated that this amount would result in outlays of $282 billion. In contrast, the Congressional Budget Office (CBO) estimated that appropriations of this magnitude would result in outlays of $297 billion, or $14.5 billion higher than the amount estimated by the Administration. Our estimating differences with the Administration were concentrated in three appropriation categories: operation and maintenance (O&M); procurement; and research, development, test, and evaluation (RDT&E). Incidentally, CBO and the Administration have never had an estimating difference of that magnitude before.

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reliable guide for predicting future outlays. The Administration assumed that history would not be a reliable guide because of management initatives and other factors that would tend to reduce outlays. In fact, as we showed in our Analysis of the President's Budgetary Proposals, published last February, we had little disagreement with the Administration as to what the historical rates were--only if they were still relevant.

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THE DIFFICULTIES IN MANAGING OUTLAYS

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Procument	78.1	75.7	2.4	77.7	79.1	-1.4	11.4	78.4
RDT&E	30.3	28.7	1.6	31.8	30.0	1.8	18.6	32.2
Military Construction	5.0	4.5	0.5	5.0	4.8	0.3	17.3	5.0
Family Housing	2.6	2.4	0.2	2.6	2.6	0.1	9.6	2.9
Revolving Funds and Other-DoD	0.3	1.6	-1.4	0.7	1.4	-0.7	54.7	1.2
Subtotal	262.1	258.4	3.6	265.5	263.5	2.1	9.7	269.1[a]
DOE & Other	7.5	7.5	*	7.8	7.9	-0.2	6.2	7.6
Total 050	269.5	265.8	3.7	273.3	271.4	1.9	9.5	276.7

SOURCES: Congressional Budget Office and Office of Mangement and Budget.

a. This amount is not the sum of the preceding categories; rather, it is an extrapolation of aggregate growth based on a 9.7 percent aggregate growth rate over total 1985 outlays of $245.3 billion. The sum of the extrapolations of the first seven categories is $268.4 billion.

63-249 0 - 86 - 2

Defense Department, in particular, should manage its program so that outlays hit some specific target. In February, the Administration argued that it could manage its outlays to acheive its defense outlay estimates through various policy changes and other measures. CBO believed that these factors could affect outlays by only a small amount, if at all. What impact they might have should be temporary and would not affect outlays beyond a few months. We discussed this at some length in our analysis of the President's budget for 1987. 1/

We believe that managing outlays would be difficult because of the decentralized nature of the defense finance and accounting system. Managing outlays would require fundamental changes in the way thousands of programs are pursued and in the business practices of equally numerous finance officers. To make a reasonable attempt to meet an exact outlay target would require an intricate set of controls that would take a long time to develop. Certainly, one should not expect such a system to yield much more than marginal savings during 1987.

Even over the long term, a number of considerations would affect the desirability or practicality of moving toward outlay management. One such difficulty stems from the fact that about a third of all defense outlays result from prior-year appropriations and contract commitments. Controlling these outlays would be difficult because, as contractors make deliveries, they expect to be paid. In those instances where delays are

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1. See Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1987 (February 1986), Chapter III.

legally possible, they may induce contractors to raise future contract bids, thereby raising the cost of procurement.

One way to manage outlays, however, is to slow obligations. Yet, this avenue has certain problems that stem from conflicting objectives of keeping outlays down and, at the same time, using appropriations to serve their purpose of improving national defense. Further, the ability to slow obligations is constrained by time limits on the availability of funding. After these limits are reached, unobligated funds lapse or are no longer available. To the extent that obligations were slowed, inefficiencies and cost growth might result, making the slowdown undesirable even if it were possible. Obviously, these problems would be less severe the smaller the attempted reduction in outlays.

A recent study by the RAND Corporation for the Air Force made many of these same points and others. [2/] The study concluded that moving toward outlay controls would require immediate attention to:

1. Bringing outlay planning into the defense planning, programming, and budgeting system so that plans reflect long-term outlay concerns (to include better forecasting and tracking of outlays);

2. Identifying within the year adjustment measures and their effects so that fine tuning of outlays could be based on priorities; and

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2. Massey, H.G. et al, Air Force Outlay Control: Management Implications and Options, (Santa Monica, California: RAND Corporation, 1985).

3. Establishing a central authority for implementing adjustment measures within the year.

Perhaps the most important observation of the RAND study was that:

> "Financial management under outlay budgeting appears to require greater budgetary discretion for the Executive branch than is likely to be acceptable to the Congress."

In particular, the study found that authority and flexibility were critical to effective outlay control and that to provide them would require giving the Executive branch greater reprogramming and impoundment authority as well as reducing full funding of procurement.

CONCLUSION

In conclusion, Mr. Chairman, while outlay estimating is difficult and inexact, CBO estimates are holding up very well. We have had to make only small adjustments to our estimates as outlays for 1986 have come in very strongly.

MARGIN OF ERROR IN ESTIMATING OUTLAYS

Senator STEVENS. I have been called to another committee. I will be right back. I am going to ask Senator Rudman and Senator Proxmire to continue with the hearing. I want to ask one question before I go.

If you have that kind of $2 to $3 billion margin of error in estimating outlays, why do you hold us to a $50 million error limitation?

We have to hit this within $50 million. Yet your process had a 2 to 3 percent margin of error which is $2 to $3 billion. Actually applied to this bill, almost $300 billion, it is more than that.

When you review our work product, you tell us we have to come within $50 million based on your projections, but your projections have a 2 to 3 percent margin of error.

Why cannot we have a similar margin of error?

Mr. PENNER. That is a problem that permeates the whole budget process.

Senator STEVENS. Gramm-Rudman gives us a $10 billion margin of error in terms of sequestering. We have problems with this because of what it is going to mean this year when we have been warning about this bow wave in outlays for a long time. No one has listened. This time we are seeking. This bill is sinking because of outlays this year.

It will draw down budget authority that is needed in the out-years. I just think something has to be done to rerationalize this way of estimating our outlays or we are going to be in real trouble.

I will be back. I hope these gentlemen will continue. I think we have to get to that margin of error concept. It applies, by the way, to what Senator Proxmire has raised in terms of inflation. There ought to be a margin of error in inflation to take into account, too.

If it is going up, it applies, if it is going down, it applies, it still comes out the same in terms of a more leveling impact of the inflation spiral.

I criticized President Carter for not putting enough in. I was right. It went up faster than they estimated. Senator Proxmire has criticized this administration for not estimating it going down as fast as it went down. Somehow or other there ought to be some compensating factors.

Mr. PENNER. Did you want me to answer that now or wait until you come back?

Senator STEVENS. I will come back.

Senator RUDMAN [presiding]. Senator Proxmire.

ADMINISTRATION'S ESTIMATED DEFICIT

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Dr. Penner, do you agree with the administration's new estimated deficit of $230 billion for 1986?

Mr. PENNER. $230 billion?

Senator PROXMIRE. $230 billion. I understand their latest estimate is $230 billion, just released yesterday.

Senator Rudman: For 1986.

Mr. PENNER. Our estimate is a little lower, sir. We are estimating about $224 billion in our report.

Senator PROXMIRE. You see no reason on the basis of recent developments taken into account by the administration to raise your estimates?

Mr. PENNER. We have raised our estimates quite considerably, but we have not raised them as much as the administation did for 1986.

Senator PROXMIRE. I said in my opening remarks that if you increase the inflation assumption by 1 percent per year, you can lower the estimated deficit in the budget request by a total of $85 billion in the next 5 years.

Do you agree with that?

Mr. PENNER. Are you talking about the budget as a whole, sir? Let me check that with our own sensitivity numbers here.

Senator PROXMIRE. I am talking about the budget as a whole.

Mr. PENNER. According to the analysis that we do, the budget is currently pretty much neutral with regard to inflation. That is because we have now indexed the personal income tax. We used to get an enormous profit, as it were, from bracket creep, which is no longer available.

If you take into account the changes in inflation, in its effect on both the outlay and revenue side, we would have a much lower number than that. However, our numbers assume that interest rates come down in accordance with inflation rates so that the real rate remains the same.

Senator PROXMIRE. Is that the principal difference between you and the administration?

Mr. PENNER. I thought the interest-rate adjustment was in the administration's estimate as well, but I can take a look at that. Are you looking at their sensitivity tables?

Senator PROXMIRE. Yes; sensitivity of the budget economic assumption. They say $3.9 billion in 1987, $9 billion in 1988, and $12.7 billion, $16.9 billion, and $16 billion. It adds up to $58.5 billion in the next 5 years.

Mr. PENNER. I suspect that amount does not take into account the effects of inflation on interest rates. I think we would have very similar estimates if we just said that nominal rates were not affected by inflation.

ADMINISTRATION INFLATION FORECASTS

Senator PROXMIRE. The administration has been high in its inflation forecasts by several percentage points in each of the past 5 years.

Among other results, did this not also have the effect of lowering the expected deficit, and does this partly explain why the administration is overly optimistic about reducing the deficit?

Mr. PENNER. I think the main reason really involves rates of economic growth as opposed to inflation assumptions. The administration has been very optimistic about those rates of economic growth, but the world has not turned out quite as well as they expected.

INFLATION DIVIDEND

Senator PROXMIRE. You are aware that the Defense Department has received billions of dollars each year in excess inflation funds.

Do you have an estimate of how much the inflation dividend will be in fiscal 1986 and fiscal 1987 and how the midyear revision will influence it?

Mr. PENNER. As you noted in your opening statement, discussion of this issue is terribly complicated because of all the reprogramming that goes on. If you were to start at the beginning of 1986 and say there would be no reprogramming, that we should follow exactly the priorities in the President's budget, we would estimate that in 1986 the excess money would be about $6 billion.

In 1987 they dispensed with this extra premium that you referred to—that is, the 30 percent extra inflation assumption for certain types of procurement. For that reason and others, we would now see in the President's request only about $900 million more for that than would be needed to cover inflation.

LEGISLATIVE PROPOSAL

Senator PROXMIRE. One other question. I have drafted a legislative proposal that would do three things: 1) It would require the Pentagon to give Congress more information about the amounts needed to offset anticipated inflation; 2) it would control inflation expenditures by earmarking the funds requested for inflation and providing that unexpended funds lapse at the end of the year; and 3) it would provide a system for tracking the expenditure of inflation funds.

Will you comment on this approach and state your own views on how to solve the problem of the inflation dividend?

Mr. PENNER. As I said, it is very hard for either us or GAO, which has 20 times as many people as we have, to really track this through time because of deficiencies in the accounting system and because of all the changes that occurred during the year in what the Pentagon actually buys compared with what they plan to buy.

So, a system such as the one you described would put into place an accounting system that would give us a lot better information about what is going on. It would, obviously, have some cost.

As has been discussed here, part of the problem in recent years has been the extraordinary volatility in the overall inflation rate and the fact that economists generally, not just the administration, have made some very bad mistakes about how fast inflation would go up in the 1970's and how fast it would come down in the 1980's.

One can always hope that such volatility will be reduced. But as I see what has happened to oil prices in the last few days, I am afraid I cannot give too much hope for that.

Thus, clearly more information is better. It costs something. We have done a paper, sir, that considers your kind of approach and considers other kinds of approaches to this problem of inflation accounting. I would be glad to share that study with you and your staff.

Senator PROXMIRE. We would appreciate that. It seems to me the very volatility and errors that have been made in the past suggest we should have something of this kind so that we get more information and be more aware of it so that we are able to have some control.

Thank you.

Thank you, Mr. Chairman.

Senator RUDMAN. Mr. Penner, would you mind waiting a reasonable period of time until the chairman comes back?

SUBMITTED QUESTIONS

The committee has additional questions which we will ask you to respond to for the record.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

ADDITIONAL COMMITTEE QUESTIONS

Question: Dr. Penner, can you tell us what your estimate for DoD outlays was for fiscal year 1986 and what you are now projecting.

What are the OMB's estimates?

Answer: Last February, we estimated that DoD outlays would total $262.1 billion, but we now estimate that they will total $265.5 billion. OMB estimated outlays to be $258.4 billion, but now estimates that DoD outlays will total $263.5 billion. Some detail behind these estimates are shown in the table.

COMPARISON OF DEFENSE OUTLAY PROJECTIONS
FOR FISCAL YEAR 1986 (In billions of dollars)

Category	Feb. 1986 Estimates			Aug. 1986 Estimates		
	CBO	OMB	Diff.	CBO	OMB	Diff.
Military Personnel	71.7	71.4	0.3	71.2	71.4	-0.3
O&M	74.1	74.1	a/	76.5	74.1	2.4
Procument	78.1	75.7	2.4	77.7	79.1	-1.4
RDT&E	30.3	28.7	1.6	31.8	30.0	1.8
Military Construction	5.0	4.5	0.5	5.0	4.8	0.3
Family Housing	2.6	2.4	0.2	2.6	2.6	0.1
Revolving Funds and Other-DoD	0.3	1.6	-1.4	0.7	1.4	-0.7
Subtotal	262.1	258.4	3.6	265.5	263.5	2.1
DOE & Other	7.5	7.5	a/	7.4	7.6	-0.2
Total 050	269.5	265.8	3.7	273.3	271.4	1.9

SOURCES: Congressional Budget Office and Office of Management and Budget.

a. Less than $50 million.

Question: Is the fact that FY 1986 outlays are running ahead of your original projections the basis of your higher estimate for 1987 outlays compared with that of OMB?

Answer: Our estimate for 1987 outlays was $14.5 billion higher than the OMB's estimate even before we knew much about 1986 outlays. The estimating difference occurred because CBO and the Administration had different assumptions about the relevance of historical spending patterns. CBO assumed that history would continue to be a reliable guide for predicting future outlays. The Administration assumed that history would

not be a reliable guide because of management initiatives and other factors that would tend to reduce outlays.

Based on the unexpectedly rapid growth in outlays during 1986, we raised our estimate for 1987 by $1.5 billion. With no change in OMB's estimate, the difference would be $16.0 billion, but OMB has raised its estimate by about $9 billion leaving a $7 billion difference between our estimates.

Question: I think it's clear CBO does a good job of estimating outlays, but can you tell us of any one year when CBO predicted Defense outlays within $50 million of its forecast? This may sound picky, but $50 million is the head room given to Appropriations bills to be considered in order.

Answer: I doubt that our outlay estimates have ever been within $50 million of actual defense outlays. The accuracy of our outlay estimates depends on many factors including the amount of budget authority provided for national defense. Consequently, the changes in budget authority for the budget year, for example fiscal year 1987, cloud any comparison. For the current year, now fiscal year 1986, our estimated budget authority is more certain and our estimates have never been within $50 million of the actual.

Question: The point here is that first year outlay forecasting is only an estimate--not an exact science. As a technical expert do you believe the Congress should have estimates of outlays bind appropriations bills?

Answer: Outlay estimates as such are inexact and for defense appropriations estimating error of 1-2 percent or $3-5 billion is common. However, they necessarily bind appropriations bills as long as the Congressional budget process--as determined by the Congressional Budget Act of 1974 (P.L. 93-344) and the Balanced Budget and Emergency Deficit Control Act of 1985 (P.L. 99-177) --focuses on specific deficit outcomes. Outlay estimates come to bind appropriation bills because it is outlays--not budget authority--that together with revenues determines the deficit.

Question: Considering that the budget authority provided in appropriations bills will outlay (spend out) sooner or later, why is a ceiling on first year outlays a useful measure of budget restraint?

Answer: Outlay estimates are divided generally into two pieces--outlays from legislation enacted in previous sessions of Congress and outlays from current Congressional action. First-year outlays relate to the latter category. Unless Congress reverses previous actions, for example rescinding budget authority, first-year outlays are the only way of affecting the deficit for the current fiscal year.

A ceiling on first-year outlays is useful as a means of ensuring that future deficit reductions are balanced against current deficit reductions. How high or low the ceiling is depends on the importance the Congress attaches to current, as opposed to future, budget restraint.

Question: Isn't it true that concentration on lowering first year outlays while appropriating a high budget authority would lead to providing large spending authority in those areas-primarily procurement-which spend out slower?

Answer: Yes, it is true that raising budget authority and at the same time lowering first-year outlays would lead to funding a mix of programs with more slow-spending programs of which procurement is the best example.

Question: Won't that have a worse effect on the 1988 deficit than a more balanced reduction across all appropriation accounts?

Answer: Appropriating more funds for weapons procurement in 1987 will certainly add to outlays in 1988 from previous Congressional action to a greater extent than if the incremental funding had gone to, say, operation and maintenance (O&M). This happens because the second year spend-out rate for procurement is greater than that for O&M. Whether such a result is worse or not depends on Congressional priorities.

Question: Dr. Penner, the OMB has testified to the Committee it can manage defense outlays, do you believe this is possible?

Answer: We believe that managing outlays would be difficult because of the decentralized nature of the defense finance and accounting system. Managing outlays would require fundamental changes in the way thousands of programs are pursued and in the business practices of equally numerous finance officers. To make a reasonable attempt to meet an exact outlay target would require an intricate set of controls that would take a long time to develop. Certainly, one should not expect such a system to yield much more than marginal savings during 1987.

Even over the long term, a number of considerations would affect the desirability or practicality of moving toward outlay management. One such difficulty stems from the fact that about a third of all defense outlays result from prior-year appropriations and contract commitments. Controlling these outlays would be difficult because, as contractors make deliveries, they expect to be paid. In those instances where delays are legally possible, they may induce contractors to raise future contract bids, thereby raising the cost of procurement.

One way to manage outlays, however, is to slow obligations. Yet, this avenue has certain problems that stem from conflicting objectives of keeping outlays down and, at the same time, using appropriations to serve their purpose of improving national defense. Further, the ability to slow obligations is constrained by time limits on the availability of funding. After these limits are reached, unobligated funds lapse or are no longer available. To the extent that obligations were slowed, inefficiencies and cost growth might result, making the slowdown undesirable even if it were possible. Obviously, these problems would be less severe the smaller the attempted reduction in outlays.

Question: What outlay management practices does CBO recognize that would have a significant impact on scoring?

Answer: There are a few management proposals affecting outlays that CBO recognizes as having a scoreable impact. These proposals could lead to a one-time savings as opposed to becoming the basis for ongoing outlay management. The proposals are as follows:

1. The Department of Defense (DoD) could be required to delay payments governed by the Prompt Payment Act until 10 days into the grace period allowed by the act.

2. The DoD could be required to set and maintain progress payments at 70 percent for large businesses and 80 percent for small businesses.

3. The DoD could be required to delay progress payments--payments not governed by the Prompt Payment Act--until 15 days after receiving a bill.

4. The DoD could be required to refuse early delivery of purchases when the delivery would lead to early payment.

These four proposals probably constitute only a partial list of the possibilities.

The key scoring problem is quantification where one would have to know in most cases what current practice is, how large a volume of transactions is affected, and the likely contractor response. For example, a refusal to accept early delivery may only lead to negotiated delivery dates that are sooner than they otherwise would have been. Also, extra financing or carrying costs that contractors must bear under some proposals might lead to higher bids and costs of procurement thus offsetting some potential savings.

Question: Dr. Penner, some consideration has been given to placing a cap on outlays to hold spending to levels required under the budget resolution. Do you feel this is feasible?

Answer: The feasibility of placing a cap on outlays to hold them to the levels of the budget resolution depends on a number of factors--especially the level and mix of budget authority and what level of outlays would occur in the absence of a cap. As I said in answer to a previous question, we believe outlay management is difficult and the degree of difficulty rises with the attempted change in outlays.

Question: What stipulations would CBO require to score an outlay ceiling as binding?

Answer: I believe that a meaningful outlay ceiling must contain the following elements:

1. The limitation must specify what actions are to be taken by the Executive Branch to limit outlays.

2. The limitation must give the authority to take these actions if that authority does not already exist.

3. Somebody has to be held accountable for seeing that the limitation is implemented. This implies the limitation makes some official of the Executive Branch responsible for implementing the limitation and requires the official to report periodically to the Congress on the limitation.

In short, the Executive Branch must consider the limitation binding and will take whatever actions are necessary to comply.

Question: Dr. Penner, most investment accounts are available for obligation for three years. Isn't it logical to assume if that availability were extended for another year or two that obligations and outlays, would decrease in the first year of availability?

Answer: I'm not sure that would be the case because it might be that the length of availability has no effect on first year obligations for multi-year accounts. It is possible that first year obligations would be unaffected because even under current law they could be postponed another year or two before availability becomes a problem. A more likely outcome, in our view, is that last minute obligations and consequent outlays would be postponed.

Question: The prepared statement of the Deputy Secretary of Defense states extending availability "would spread outlays over a longer period of time." Do you agree?

Answer: I would agree that it is more likely that second, third, and later year outlays would be delayed than first-year outlays. I do not know what that likelihood might be or how much money might be involved. Like many proposals, quantifying the impact is less obvious than the direction of the change.

Question: What would be the effect on outlays if budget authority for a portion of an account or for a specific program were provided at a date later than the beginning of the fiscal year? (Such as April 1 or July 1).

Answer: In general, later provision would mean lower outlays as is the case with many supplemental appropriations. In some cases providing funding half way into the fiscal year might mean only half as many outlays as full-year provision, for example, a procurement program. In other cases, outlays might not be affected at all--for example, an O&M funded program where lead times between obligation and outlay are relatively short. The magnitude of any outlay effect would depend on the program and the certainty of the availability.

Question: What specific provision or report language would be required in an appropriations bill mandating such a delay that would effectively reduce outlays in CBO's scoring?

Answer: Scoreable language must appear in a bill as opposed to a report. Such language must stipulate the program(s) to be delayed and the date on which obligations could be incurred.

Question: The Armed Services Committees are considering a delay of the payday for military personnel from September 30, 1987, to October 1, 1987--a slip of only one day. What are the savings associated with this change?

Answer: Delaying the payday for military personnel from the last day of one month to the first day of the next would save about $4.4 billion in outlays in function 050, but only about $2 billion from the budget taken as a whole. The net savings are lower because of certain offsets in spending and revenues associated with retirement accrual, FICA, and income tax withholding. About $1.6 billion of the savings in military personnel outlays would be offset by foregone receipts in the military retirement trust fund (budget function 950). Another $0.8 billion of military personnel savings would be offset by lower revenues since the Treasury would not receive the FICA and income tax withholding. Thus, there would be a net budgetary savings of $2.0 billion.

Question: Dr. Penner, what is the inflation forecast for FY 1987 assumed in the budget resolution?

Answer: The Budget resolution assumed that the change in the GNP deflator would be 4.1 percent during calendar year 1987.

Question: In your upcoming snapshot on August 15, will you be changing the inflation forecast?

Answer: We forecast a change in the GNP deflator of 3.9 percent during calendar year 1987. We will use this forecast in our August 20 report with the Office of Management and Budget.

Question: There has been considerable controversy over inflation windfalls in the Defense Department. Recently, the CBO published a paper which seemed to indicate there is between $8 and $12 billion in excess inflation funds in 1986 and 1987 in the Defense Department (funding and budget request). Are you familiar with this paper and what can you say about the excess inflation in the defense budget?

Answer: I believe the paper you are referring to is a letter in response to a request from Senator Bumpers. The letter was prepared using varying assumptions regarding future inflation that were prescribed by the Senator's staff. It showed the hypothetical budget authority savings that may accrue

to the Department of Defense given all of the assumptions described in the letter, and the varying assumptions regarding future inflation. These hypothetical budget authority savings range between $7 and $10 billion, depending upon which set of inflation assumptions are used.

Based upon CBO's most recent forecast, and assuming no reprogrammings or other appropriations reductions, the potential amount of excess 1986 budget authority as a result of updated inflation assumptions from the post-sequestration er level is approximately $6 billion. This calculation applies only to non-fuel purchases of the DoD and assumes that the post-sequestration budget authority was based on the rates included in the Administration's February 1985 budget submission. For 1987, substituting CBO's August inflation assumptions would produce potential savings of $900 million from the President's February budget request.

Question: Did this paper take into consideration the reductions made in FY 1986 appropriations to the defense budget which were directly and indirectly related to inflation?

Answer: The hypothetical savings in the letter to Senator Bumpers did not take into consideration the reductions made in the FY 1986 appropriations to the defense budget that were directly and indirectly related to inflation. The calculations also did not attempt to track reprogrammings and other actions that may have reduced the remaining amount of excess funds from inflation adjustments.

Question: How much extra funding for inflation remains in the prior year budgets?

Answer: We are not able to estimate how much excess funding for inflation remains from prior-year budgets. We know it has been reduced because Congress denied for 1986 funding for the 30 percent inflation premium; there have been many reprogrammings; and, the 1986 sequestration reduced overall funding. These factors, together with the absence of an accounting system that keeps track of inflation funding, preclude an estimate.

DEPARTMENT OF DEFENSE

SECRETARY OF DEFENSE

STATEMENT OF HON. WILLIAM H. TAFT, IV, DEPUTY SECRETARY OF DEFENSE

ACCOMPANIED BY HON. ROBERT W. HELM, ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

OUTLAYS AS FUNCTION OF DEFENSE BUDGET

Senator RUDMAN. I would like to call the Deputy Secretary of Defense, Mr. Taft, and the Assistant Secretary, Mr. Helm, if they will come forward now. We might be able to save some time that way.

Mr. Taft, we have your full statement. We would appreciate it if you would summarize it. If you feel you would like to address the entire statement, that is your choice.

Mr. TAFT. Very good, Mr. Chairman. Thank you very much.

Senator RUDMAN. Your entire statement will be inserted in the record.

Mr. TAFT. It is a privilege to appear before the committee on the important subject that you have scheduled for today, the matter of outlays and how they are a function of the defense budget.

Traditionally, outlay estimates have been regarded as simply that, as estimates. Mr. Penner has indicated the difficulties that go into estimating and I think they are very real. And, we do not have any disagreement with the points that he has made about the complexity of accurately estimating outlays for something the size of the defense budget or, indeed, even more in the case of the budget as a whole.

It has been said that the outlays for the fiscal year 1987 budget in defense are too low. I can say if that is the case, it would be unusual. In the past we have tended to overestimate our outlays. This was true particularly in 1983 where we had a $4 billion overestimate, in 1984 where we overestimated by $10 billion and in 1985 where we overestimated by $2 billion.

OVERESTIMATE OF CURRENT BUDGET OUTLAYS

My feeling is that fiscal year 1986 outlays also were probably originally overestimated in the President's budget, but I would agree with Dr. Penner that they were underestimated in the congressional budget resolution of last year for fiscal year 1986 and also continued to be underestimated in the projection made in the President's fiscal year 1987 budget, the fiscal year 1986 column of that.

63-249 O - 86 - 3

But the 1 to 2 percent deviation figure that he gives, we have no quarrel with that. That certainly reflects historical experience. It is about as close as people tend to be able to come.

GRH EFFECT ON OUTLAY ESTIMATES

Today the current fiscal climate and deficit reduction legislation have dramatically changed the environment in which we develop and review what used to be simple estimates. Because of Gramm-Rudman-Hollings legislation, outlay estimates have become something else.

They have become a ceiling that imposes additional constraint on the budget process. They have become targets. They have become requirements. Outlay projections of $282 billion were included in the President's budget for defense in the original submission.

They were the result of estimating, but they also were the result of conviction on our part that in view of the different character of this figure, being not just an estimate, but in the Gramm-Rudman-Hollings context a requirement, that they should reflect the introduction of management efforts we might have and we should stick to them and be committed to get them.

I should say the figure of $282 billion that was submitted in the President's original budget was also consistent with the estimates or, perhaps even though it was in a pre-Gramm-Rudman document, they were already targets, already requirements, in the congressional budget resolution for fiscal year 1986 and what it projected for fiscal year 1987, its fiscal year 1987 outlays.

Whatever may have been the case, today, of course, we confront a very different congressional budget resolution from what the President's budget submitted in January of this year. That budget resolution says that we should have $292 billion in budget authority and $279.2 billion in outlays for defense.

If the Congress approves the $292 billion in the fiscal year 1987 budget authority for defense, the Department believes that it should, and it will, work with the Congress to achieve the outlay figure also contained in the budget resolution of $279.2 billion.

We are confident that we can manage outlays sufficiently to achieve this level. In the spirit of Gramm-Rudman which calls not just for an estimate, but prescribes a target, we will turn this estimate into a target, indeed into a requirement.

PROPOSALS ASSURING ESTIMATED OUTLAYS

To this end, I would like to outline for you a number of proposals that we would employ to assure that outlays fall within the estimate. Implementing these proposals will require congressional support.

The Department has developed proposals that will maximize our ability to constrain outlays to the level proposed in the budget resolution. We are reviewing, among other things, the flexibilities available to us under the Prompt Payment Act.

BILL PAYING

I find, much to my surprise, that we are paying bills too early. Our current operating procedures will, therefore, be amended to issue checks for days later than is presently the practice and is permitted by current law.

To do this would reduce outlays as much as $1.2 billion in fiscal year 1987 from the situation if we were to continue the present practice.

Further, the Prompt Payment Act provides a 15-day grace period after the payment due date before any interest penalties are incurred. If we delayed payments by 10 days into that period, we estimate that we would reduce outlays by an additional $2.8 billion in fiscal year 1987.

PROGRESS PAYMENTS

In April 1985, progress payments were reduced from 90 percent to 80 percent for large businesses and from 95 to 90 percent for small businesses. We think that for fiscal year 1987 we could reduce that percentage by another 10 percent for large businesses to 70 percent and this would result in a saving of $1 billion in outlays in fiscal year 1987 and $3 billion in fiscal year 1988.

It is true, as Dr. Penner suggested, that after fiscal year 1988, increased payments at the time of delivery would have offset reduced front-end progress payments, but no increase should be expected overall as long as the rate is maintained at the new lower level.

We feel that because interest rates and inflation have declined, that this reduction in progress payments would result in no additional or unfair burden to the defense industries, that it can be managed. We have identified no adverse effects from the reduction that we put into place last year from 90 to 80 percent.

We would also propose to slow progress payments by specifying, beginning September 1, progress payments are to be made no earlier than 15 days after submission of a bill from the contractor for all payments except those related to small businesses. This criteria represents a 10-day delay in the progress payment schedule compared to the average 5-day period now being experienced and would result in further reduction of $1.8 billion in outlays in fiscal year 1987.

We also propose that beginning the month of December 1986 military pay and allowances and related amounts of Federal taxes and retired pay contributions normally paid on the last day of the month be paid on the first day of the following month. For fiscal year 1987 this has the effect of reducing outlays from the 050 function by $4.4 billion, about one-half of which would be reflected as a reduction to the deficit. The other one-half, of course, is a reduction in the payment we make to the Treasury.

EXTENDING OBLIGATION AVAILABILITY PERIODS

Extending the current obligation availability periods for procurement appropriations also makes good business sense. We would request your cooperation in extending the 3-year availability of procurement ap-

propriatons to 4½ and extending to 7 years shipbuilding accounts from the current 5 years. This would be consistent with the pattern of expenditure that we think we could have and it would also have the effect of slowing some outlays.

GOODS AND SERVICES DELIVERIES

We would amend the current practice of routinely allowing early delivery of services and products under contracts with subsequent early contractor billing. Currently our contracts specify that goods and services will be delivered consistent with given delivery dates and schedules. But early delivery is permitted and routinely occurs, even in cases where there is no real advantage to the Government in receiving the item early.

Now, the contractor submits his bill on the early delivery and essentially we make an earlier payment than we would have to if he did not make the early delivery. We estimate we can make about a $500 million saving in outlays by terminating this practice.

CONTROL OF OBLIGATIONS

Finally, it is important that the Congress recognize that the Secretary of Defense have the authority to control obligations in order to constrain outlays and also acknowledge the outlay reductions identified here should be scored by the Congress in order to have the desired effect of constraining defense outlays in the context of the Gramm-Rudman-Hollings legislation.

I should say, Mr. Chairman, that not all of these proposals would be considered appropriate under the normal circumstances, nor would they be followed if we were merely in a situation where we were estimating outlays in order to develop broader fiscal policy which has, of course, been the practice traditionally.

But we are now in a situation where these estimates, as I say, have become targets, have become requirements, and we feel it is our job to propose to you ways in which we can meet them. These are the requirements in the congressional budget resolution just passed 6 weeks ago. We think they can be met and we would enlist your support in meeting them.

What we do not think is a wise thing to do in any case, nor a necessary thing to do, is to reduce budget authority, which in turn would reduce our abilty to obtain needed defense equipment now and to contract for it.

We do not think that is necessary. We think the budget resolution has set a target. We can meet it. We think that is what we should do and we will work with the committee to produce that result.

I will be glad to take any questions.

[The statement of Mr. Taft follows:]

PREPARED STATEMENT OF HON. WILLIAM H. TAFT, IV

DEPUTY SECRETARY OF DEFENSE

Introduction

Mr. Chairman and members of the subcommittee, I am pleased to have this opportunity to be here today to discuss outlays as a function of the defense budget.

Traditionally, outlay estimates have been regarded as simply that - estimates. Outlays do not lend themselves to the mechanistic application of fixed rates. For the Department of Defense, outlay projections must take into consideration the program mix submitted with the budget, since operations funding spends out more quickly than investment funds. Outlays also depend on prior year budget authority levels, and the programs they fund. Finally, program management and execution can significantly affect outlay rates. I will discuss this in more detail later.

Some have said that the defense outlay projections in the FY 1987 budget are too low; if so, this would be unusual. In the recent past we have generally overestimated defense outlays and been criticized for it. Some have even cited this as evidence that we cannot spend money as fast as we plan. In FY 1981, we overestimated outlays by $1.6 billion, while in FY 1982 we underestimated by $50 million. In FY 1983, we overestimated defense expenditures by $4 billion; in FY 1984, we overestimated by $10 billion; and in FY 1985, we overestimated by $2 billion. FY 1986 outlays were probably originally overestimated in the President's budget, but underestimated in the congressional budget resolution and the FY 1987 budget. Historically, the Department's outlay projections have been within 1-2 % deviation of actuals.

Today's current fiscal climate and deficit reduction legislation have dramatically changed the environment in which we develop and review our budget estimates. Because of the Gramm-Rudman-Hollings legislation, outlay estimates have become ceilings imposing additional constraints on the budget process. Outlay projections of $282.2 billion included in the President's budget for defense were the result of a rigorous joint review by DoD and OMB of all circumstances affecting defense spending. These included historical estimates versus actuals, rate trends, obligation and contract award patterns, procurement reforms, lengthening leadtimes, program instability resulting from late appropriations, and Gramm-Rudman-Hollings reductions in FY 1986.

These estimates were carefully derived and reflect constrained but realistic spending levels. Some have disagreed with them. Whatever the case, today we confront a congressional budget resolution that reflects $292.2 billion in budget authority and $279.2 billion in outlays for defense. This represents a decrease of $28.1 billion in budget authority and $3 billion in outlays to the President's request of $320.3 billion and $282.2 billion respectively. Still some have voiced concern that the Congress has created a mismatch between budget authority and outlay levels for defense. If, however, the Congress approves $292.2 billion in FY 1987 budget authority for defense, the Department will work with the Congress to ensure that outlays do not exceed $279.2 billion. We are confident that, with the support of the Congress, we can manage outlays sufficiently to achieve this level.

To this end, I would like to outline for you a number of proposals we would employ to assure that outlays fall within the estimate. Implementing these proposals will require your support.

Proposals to Manage Outlays

The Department has developed proposals that will maximize our ability to constrain outlays to the level proposed in the budget resolution. In some instances, we have been able to reasonably project the estimated level of outlays that would be delayed. In others, we cannot precisely calculate the level of outlays that would be affected, but are reasonably certain they will have the desired effect.

We are reviewing the flexibilities available to us under the Prompt Payment Act. I find, much to my surprise, that we are paying bills too early. Our current operating procedures will therefore be amended to issue checks four days later than is present practice consistent with current law. To do so could reduce outlays by as much as $1.2 billion in FY 1987. If we continue this practice, there will be no adverse effect on future years. Further, the Prompt Payment Act provides a 15 day grace period after the payment due date before incurring interest penalties. Delaying payments 10 days into this grace period will reduce outlays by an additional $2.8 billion in FY 1987.

In April 1985, progress payments were reduced from 90 percent to 80 percent for large businesses and from 95 percent to 90 percent for small businesses. Implementation in FY 1987 of an additional 10 percent rate reduction would result in reduced outlays of $1 billion in FY 1987 and $3 billion in FY 1988. After FY 1988, increased payments at the time of delivery would offset reduced front end progress payments, but no increase should be expected as long

as the rate is maintained at the new, lower level. Interest rates have declined significantly in recent years, as has inflation, and we do not believe defense industry would be overburdened by these actions.

In conjunction with this, we propose to slow progress payments by specifying that, beginning September 1, 1987, progress payments are to be made no earlier than fifteen days after submission of the bill from the contractor for all payments except those related to small business contracts. This criteria represents a ten day delay in the progress payment schedule compared to the average five day period now being experienced. This proposal will reduce outlays in FY 1987 by $1.8 billion.

We also propose that, effective beginning the month of December 1986, military pay and allowances and related amounts of federal taxes and retired pay contributions, normally paid on the last day of the month, be paid the first day of the following month. For FY 1987, this has the effect of reducing outlays from the 050 function by $4.4 billion, about half of which would be reflected as a reduction to the deficit. A one day delay in receipt of pay and allowances would cause minimal temporary economic disruption to military members.

Extending the current obligation availability periods for procurement appropriations makes good business sense. We request your cooperation in extending the current three year availability of procurement appropriations to four. We propose that shipbuilding appropriations be extended to seven years from the current five. The Congress and the Adminstration have taken great steps to improve the procurement process and to improve defense acquisition in recent years. But, these efforts have not been without a price. The myriad of procurement reforms designed to enable us to "do it right the first time" has slowed the process. Procurement leadtimes have lengthened to accommodate new audit and other safeguard procedures. The extended availabilities would provide additional time to execute programs and would spread outlays over a longer period of time. We would continue the congressionally supported full funding policy to ensure that sufficient budget authority is requested for procurement programs in order to initiate contract awards.

We would amend the current practice of routinely allowing early delivery of services and products under contract, with subsequent early contractor billing. Presently, the Department's contracts specify that goods and services will be delivered consistent with given delivery dates and schedules, but early delivery is permitted and routinely occurs even in cases where there is no advantage to the government. The provisions of the Federal Acquisition Regulation (FAR) allow the contractor then to submit his bill, making

early delivery tantamount to early payment. It is estimated that this action will reduce outlays by approximately $.5 billion in FY 1987.

Finally, it is important that the Congress recognize that the Secretary of Defense have the authority to control obligations in order to constrain outlays and also acknowledge the outlay reductions identified here must be scored by the Congress in order to have the desired effect of constraining defense outlays in the context of the Gramm-Rudman-Hollings legislation.

Conclusion

While not all of these proposals would be considered appropriate under normal circumstances, the current fiscal environment dictates that efforts be made to constrain outlays to ensure that outlay ceilings are attainable. These proposals are feasible and will not have any deleterious effects on program accomplishment.

The congressional resolution reduction of $28.1 billion in budget authority already represents a significant loss of defense programs from the President's request. To achieve further outlay reductions through even lower levels of budget authority, as some suggest, would abandon defense strategy and priorities to a balance sheet. It is much better to delay outlays than to delay acquisition of necessary weapons systems. To delay acquisition entails risks by denying our forces much needed capability.

It is important to remember that a defense program that costs less is not without its price. With the support of the Congress we can use the tools available to us to constrain outlays to achieve the level specified in the budget resolution without imposing additional reductions to the defense program.

Thank you, Mr. Chairman. I will be happy to answer any questions you and the members may have.

GENERAL QUESTIONING

Senator RUDMAN. Mr. Helm, do you have any prepared comments at all.

Mr. HELM. No.

Senator RUDMAN. Mr. Secretary, thank you very much for being here this morning. We recognize you have a difficult job. We recognize that we now have constraints on outlays that historically, of course, have not been the currency of budgeting.

I want to assure you that my questions are not in any way hostile because I recognize that you are dealing within the constraints that you

have to deal with and you do what you have to do. I must make the observation that the hearing was called to find out precisely what you have testified to and what Mr. Penner has testified to. We appreciate that. That is why this hearing is truly informational.

BOOKKEEPING FUNCTIONS

I do not have a lot of questions this morning. Quite frankly, what we have heard this morning essentially addresses a number of what I would call bookkeeping functions in most cases.

If you delay paying the troops by 1 day, if you delay paying contractors 5 days, the problem only moves into 1988 unless you do it again. What I am saying is that if a family had a budget of $3,000 a month and they were very short on money, they would go bankrupt. I expect that their budget would look much better on a cash flow basis.

Of course, they might have the electricity shut off and the oil man might not deliver the oil, which in my State would be pretty serious in the wintertime.

You may theoretically help to reach the target, but does this really do what we are trying to do, which is to try to better control the spending?

None of these are structural. They tend to be procedural.

Mr. TAFT. They will have different impacts. Let me address what I think is the main thrust of your question, Senator, because it is an important one.

What we are faced with, what we have been faced with in the Department of Defense over the years has been recommending to the Congress the defense program that we need for protecting our security and interests. That is principally the way we develop our budget and in the past we have let it stay at that.

We have estimated the program required. The committees up here I think have approached it equally that way. They have addressed our program and the outlay estimates are things that Dr. Penner and the OMB worried about. If they came within 1 or 2 percent, they felt good and that was the end of it.

We are now, because of the Gramm-Rudman-Hollings statute, in a cash flow world. Our attention has been called not simply to the defense program and to executing our obligations as best as we can, but we have been told cash flow is important. That is what Gramm-Rudman-Hollings does to us.

It says, yes, you must look at cash flow, that is important. So, indeed you are right, these are not things that in the past this committee would have concerned itself with. One or 2 percent would have been good enough for it. The same from the Defense Department perspective.

But today I have been told that Congress has decided that is not good enough. We must do better and it is a cash flow matter and when you are in a business the size of mine where we are obligating $26 billion a month, cash flow, $24 billion a month, whatever the rate might be, it is in that vicinity, the cash flow matters. These are cash flow things and we can make up a lot of cash flow.

ONE-YEAR ADJUSTMENTS

Senator RUDMAN. But these are one-time adjustments in the sense that they are going to help us in 1987. Obviously, unless you make other adjustments, those adjustments are lost to you in 1988. You can try again, but you will have an incremental pickup from 1987 to 1988.

So, it does not buy us a great deal, is that not correct?

Mr. TAFT. That is half correct——

Senator RUDMAN. That is better than I usually do.

Mr. TAFT [continuing]. In this sense. It may be totally correct, depending on how you meant it, Senator. But the point is that these will save us money in fiscal year 1987. They will not add to the outlays in fiscal year 1988. None of the things I recommended, unless we reverse them and we would not have any intention of reversing them, would add to the outlays in fiscal year 1988. That is an important qualifier.

Senator RUDMAN. That is correct. My question was posed in terms of the 1988 outlays.

Mr. TAFT. They will not reduce outlays in fiscal year 1988 as much as they do in fiscal year 1987.

Senator RUDMAN. That option will be lost to you as it relates to this problem when you are sitting here a year from now. You say we will do it again.

Mr. TAFT. They will not make our situation in fiscal year 1988 any worse——

Senator RUDMAN. Or easier.

Mr. TAFT [continuing]. Or easier than it is now, but they will make our situation easier.

Senator RUDMAN. If I do not pay my bills this month, my checking account will look healthy. It may be I am stealing, I am warm and happy, but it is illusory.

Mr. TAFT. Not if you do not make your situation next month any worse.

OMB BUDGET AUTHORITY

Senator RUDMAN. Mr. Taft, yesterday's reassessment by OMB budget authority for fiscal year 1987 was reduced by $23.1 billion.

My question is: Have you been directed by OMB to submit a budget amendment to reflect this adjustment?

Mr. TAFT. No, Senator, we have not.

Senator RUDMAN. Do you expect to be so directed?

Mr. TAFT. No; we would not expect to do that. What we are doing is working with the committees, including this one, the authorizing committees and the House Appropriations Committee as well. All of them have developed proposals that conform to the congressional budget resolution which is in the $292 billion range.

We have advised them of our views on that and I think that is probably the best way to treat the budget from now on. There is not any lack of good things that the Congress could spend the $292 billion on. They are useful things. They would contribute to the security of the country.

We will work with the Congress to identify which ones of those can be fit into the budget level that is now determined.

Senator RUDMAN. I guess that answers the question. I asked you that for this reason. The budget request was originally 3.13, authority was which brings it down to 3.07. Had we had that as a 3.07 submission last January or February, of course, then we would have been able to look at your priorities.

BUDGET PRIORITIES

What I am asking you is: You do not intend to come up and declare a new set of priorities and state that you will work within our resolution to reach that figure. Is that your answer?

Mr. TAFT. We are working with each of the committees and with this one to the extent that it desires to put the best budget together within whatever level it determines. It seems now that the level for the defense budget is settled before the inside of the budget is settled. That seems to be the way the Congress goes about it.

We are glad to work with all of the committees to tell them what we would put within any given budget levels. We have been doing that with all of the committees.

As I say, the bill is on the floor now at $295.6 billion, I believe, from the Senate Armed Services Committee. We have worked very closely with them in putting that bill together and we support it.

Senator RUDMAN. The resolution plus the reserve which is a creative——

Mr. TAFT. That is another $7 billion on top, yes.

Senator RUDMAN. Is that where you come up with your $299 billion figure with the reserve?

Mr. TAFT. That is right. Our approach, Senator, is essentially this: To go through the process with the committees of enacting the bills that they want to enact—we have not just one bill, but, obviously, then the conference and then the appropriations bill—to see where we are and if we need more, we will certainly advise you of that and exactly what it might be.

Until we see what is actually in the bills, we do not know which of the things you do not have to ask for.

Senator RUDMAN. One of the problems that this committee has had, and I know the chairman has not been pleased about it, has been an inability as we got down the road in the budget process to get DOD to come up and say here is reality, we face it, here are your choices, these are our priorities.

TARGETING OF BUDGET PROGRAMS

It seems, at least to me, and I have been a participant in every one of those meetings, the answer we tend to get is that we need it all. That may well be, but my question is, whatever happens with these appropriations in terms of meeting our targets? Can we expect full cooperation from DOD in identifying, if we have to make further reductions, where you would like us to make them?

You might not like it, but if we are going to do it, it ought to be done. That is my question.

Mr. TAFT. Senator, this is not the experience, frankly, that I am familiar with. We have not had any objections overall to the priorities that have been reflected in the bills that this committee has voted out with some specific exceptions in the MX and SDI which you are familiar with and we call your attention to them at the time when we do them.

On the whole, coming in at lower numbers as it has over the past 2 or 3 years and this year, the priorities that have been reflected in this committee's bills have not been criticized by the Department with the particular exceptions that I have noted.

I do not think there is any secret about the administration's priorities. Nor have they varied greatly from what this committee at lower level has reflected in its bills.

Senator RUDMAN. For example, we have a DOD bill on the floor right now. I am sure you are working to cooperate with them, but I would assume the cooperation would mean coming within the congressionally passed budget resolution.

I point out to you there is about $7 billion over in the budget resolution in outlays that is presently on the floor. That is going to give this committee, which is bound by our 302(b) subcommittee allocations, a difficult choice. That is where we will need the help of DOD to tell us where you want us to find that.

Mr. TAFT. What I have been testifying to is that we can take care of that difference, that $7 billion difference, without having to change that program at all. We think that is the right way to do it.

Senator RUDMAN. We do not necessarily accept all of that, but we are going to talk about it, obviously.

Let me ask one question of Mr. Helm.

I have been going over some numbers because this budget is not only difficult for Members of Congress who are not serving on the Appropriations Committee, but it is almost impossible for the public to understand.

You read headlines about the Congress having cut the President's defense budget. Somehow the word "request" is always left off. I want to give you some numbers. Tell me if they are incorrect. I want to be proceeding from the right base in my own thinking.

BUDGET OUTLAY AND REQUESTS

The President requested $320.3 billion, including $282.2 billion in outlays, according to DOD. Is that correct?

Mr. HELM. Yes, sir.

Senator RUDMAN. The Congressional Budget Office disagreed with that. They said that their $321.3 billion would actually be $296 billion in outlays.

Is that correct? Was that their assessment?

Mr. HELM. I believe that was.

Senator RUDMAN. Have you had any discussions with them? I am just curious—do you now agree that the $282 billion figure was probably low or do we not agree with that from the Defense Department?

Mr. HELM. We have not had any specific discussions with CBO. I think Mr. Penner accurately reflected the situation. There was disagreement between the administration and CBO on the relevance of historical outlay rates as we moved into this new environment which focused much more on hitting outlay targets and managing outlays.

To that extent there was no reconciliation. There was general agreement that the administration's request did not follow the normal historical outlay pattern. There is no disagreement about that. In fact, we made assumptions that management actions would be possible.

Turbulence of the budget environment at the moment and special actions, the unknown impact of Gramm-Rudman-Hollings sequestration on program execution in the future, all of these things called normal historical assumptions into question and warranted the number that was reflected in the President's budget.

Senator RUDMAN. We ended up with outlays of $279.2 billion; at least that is what the resolution currently calls for.

Mr. HELM. Right.

Senator RUDMAN. Now outlays, and I am speaking of outlays, for fiscal year 1986 are now estimated within this $230 billion deficit framework at $265.8 billion.

So, outlays in 1986 are estimated now to be at $265.8 billion. That is the number that is being used in the current deficit projection of $230 billion. Am I correct about that?

Mr. HELM. Yes; I believe that is generally correct.

Senator RUDMAN. I believe that is the right number.

Mr. HELM. Yes, sir.

Senator RUDMAN. I just want to make a point here for the record. Outlays in fiscal year 1986 were $265.8 billion. The Congress says that we are going to attempt to attain outlays of $279 billion. Without inflation, the adjusted increase is 4.2 percent.

Is that correct? I have done the math.

Mr. HELM. Yes, sir.

Senator RUDMAN. My point is, and I think it is an important point that will probably not be heard outside the hearing room, that with all the cries about the defense budget being affected radically by what Congress is doing, it really has more to do with what the President said he needed.

That is fine and that is giving due credence. The fact is that, assuming zero inflation, which you probably cannot, we have a real increase in dollars of about 4 percent in 1987 over what it was in 1986.

Mr. HELM. Speaking solely in terms of oulays, that is correct, Senator.

Senator RUDMAN. Quite frankly, that is what you buy and that is what you use.

Mr. TAFT. No, Senator, that is not what you buy. That is what you have bought.

Senator RUDMAN. I understand that.

Mr. HELM. A lot of that is prior year outlays.

Mr. TAFT. Outlays is not what you buy.

Senator RUDMAN. It is just what you got delivered and you paid for.

Mr. TAFT. That is different from the defense program.

INCREASED DEFENSE SPENDING FOR FISCAL 1987

Senator RUDMAN. I understand that fully. I think it is important to recognize that the Congress again this year will be spending considerably more money on defense than it did last year.

I am not saying it is enough. I am not even having an argument on that. I am going into pure numbers. Of course, probably what we will not talk about is the chairman's bow wave argument which I understand in exquisite detail and I know what the budget authority is doing in commitments and what it is doing to O&M.

We are going from $265 billion to $279 billion in outlays?

Mr. TAFT. I think that that is correct, but in fairness, it should be noted that that does not mean that the Congress this year is appropriating, as anybody can tell by looking at what they are appropriating, a stronger defense program than they did last year.

What it principally reflects is that in 1985 they appropriated a larger program than they appropriated in 1984.

Senator RUDMAN. The question then remains——

Mr. TAFT. That is where the outlays are going up.

Senator RUDMAN. The question remains: What are we going to do with the past authorizations as to whether or not we made some mistakes and whether that can save some money in the future?

Mr. Chairman, you have returned. I will yield back.

Senator STEVENS. I do not want to take the time from the Senator's who have been here.

Have you asked questions, Senator Chiles?

Go ahead.

Senator CHILES. Thank you, Mr. Chairman.

CBO ESTIMATE OF DEFENSE OUTLAYS

I listened to your answer to Senator Rudman. As I heard you say, you did not necessarily agree with the CBO's assertion that you were $14 billion under in outlays in your original budget? You did not necessarily agree with that assertion?

Mr. TAFT. That is correct, Senator. Our figure was different. In the present situation we are in where the $320 billion budget authority figure is no longer before you, I do not know that it bears relevance. As Dr. Penner said, the estimates have converged substantially in the congressional budget resolution numbers.

Senator CHILES. I would like to know if you think you were right to start with and you can have your outlay number with the BA number

of $320 billion. When you dropped your BA number by $20 billion, why did you only drop your outlays $100 million?

Mr. TAFT. This is part of the convergence I just described.

Senator CHILES. I think it is kind of wise, perhaps we have not converged enough yet, but I think it is an interesting answer. Your number was right to start with. You have this $14 billion difference, yet when you take $20 billion off BA you take $100 million off in outlays, that is arithmetic that exactly matches the arithmetic you were using in your original.

Mr. TAFT. There is a change, no question about that. We are not attempting to conceal that or pretend that there has not been a change. Dr. Penner testified about a $9.3 billion change, at least I believe he said, and that is correct.

CONGRESSIONAL BUDGET RESOLUTION FIGURES

Senator CHILES. Now, you are using the number $299 billion and you are using the number $282 billion. It is my understanding you are saying that you are picking those up now from our budget figures.

Mr. TAFT. Those are the congressional budget resolution figures, I believe.

Senator CHILES. Those are the congressional budget figures with a reserve?

Mr. TAFT. That is right.

Senator CHILES. Does this mean that you have triggered the reserve?

Mr. TAFT. No, sir. I believe the terms of the congressional budget resolution require various submissions from the President to trigger the reserve which have not been made.

Senator CHILES. How can you use those figures if we are not triggering the reserve?

Mr. TAFT. We can trigger the reserve later. The thing is not a document other than what it says to project what the status of the budget is at this time. It does not mean that additional actions would not have to be taken to bring about the figures in here. The attempt was simply to reflect what the congressional budget resolution figure was.

If you wanted to use the $292 to $279 billion figures without the reserve, that were also in the congressional budget resolution, the adjustments to the midsession projections are very simple to make and you would find a different result.

EFFECT ON BUDGET UNDER REDUCED OUTLAYS

Senator CHILES. I think there is a difference. You had a discussion again with Senator Rudman. You said that you felt, not being able to control outlays with the $299 billion figure and the $282 billion figure, that you could provide the same items, the same kind of defense budget that you provided originally, did you not?

In other words, I thought Senator Rudman was saying, should you be giving us some advice now, that is, you reduced $20 billion in BA, should you be giving us some advice on what you are going to take out of what you said you wanted in your defense budget?

I heard you say we do not have to do that. We think we can still have those items.

Mr. TAFT. No, sir, that was not the intention I had in responding to that question. What I meant to say was that the lower budget levels are not welcome to us. We do not think that they do the job.

Frankly, the Armed Services Committee in presenting its bill, the sponsors of it, Senator Nunn, Senator Goldwater, said precisely the same thing, that, it does not buy what we would like to have, what we should have, but that is not to say that we cannot work with that committee.

We have worked with that committee in fashioning that bill at that lower level so that it reflects and after the Senate has finished considering it, it will reflect the Senate's priorities within that lower number. We have done that and we will do that with this committee. It is not to say that we like that number.

It is not to say that we agree with everything in it, but there is not any failure, I really do not believe, on this committee's or any of the other committees we deal with to know what we would like to see within those lower numbers. We make it clear every day.

NEW BUDGET SUBMISSIONS

Senator CHILES. I thought Senator Rudman was trying to get at the point of should you be giving us a new submission now with these lower figures. I thought that is what he was saying.

Senator RUDMAN. That was my question. I think I heard the answer that Senator Chiles heard.

Mr. TAFT. The answer is that I think it is better for the process to work with the committees on bills they are developing and commenting on them as they go along. It is a very moving process.

DEFENSE PRIORITIES

Senator RUDMAN. How do we get the advice of the Defense Department on what its priorities should be if you change your numbers now and yet you do not give us any new advice?

We do not think we know all the answers to these things, ourselves.

Mr. TAFT. We give you advice all the time. We are working with this committee. The Senate Armed Services Committee bill reflects all of the advice that we have given them. It is a much lower number than we had originally proposed.

As I say, we do not really differ with the priorities reflected in that bill except in specific areas, and nobody is in doubt about our position on those things, on SDI and on strategic programs. People know what we think. It is not a secret.

Senator RUDMAN. I believe, if I understand his answer, that rather than respond at this time with a written list that says we have taken $23 billion of authority out of here and here are A, B, C, D, E that we would like to eliminate, we are going to do a rolling kind of consultation with the committees and look at your priorities, I think that is the answer.

I would prefer to get the A, B, C, D, E list, but I am not surprised we are not going to get it and I respect that. I just simply make the observation that had you come up with that $23 billion list at the time you made your original submission, we certainly would have had the A, B, C, D, E list because that is what the whole document is to start out with, Mr. Secretary.

Mr. TAFT. We would submit the budget with any number that is determined by the President consistent with the fiscal requirements and the national security. That is what we do. We can do it once a year. We can do it once every 6 months. We can do it once every 2 weeks.

It is better, frankly, I think to do it once a year. That is plenty. Then we work with the committees. We have four of them to work with; it is not just one. All of them have different ideas that we need to respond to and we do respond to them to tell them whether we agree with this or disagree with that.

Each committee has many members. I really do not think our views on your views are unknown.

Senator CHILES. Let me ask one question.

TRIGGERING OF RESERVE

You are using the figure of $299 billion in BA and $282 billion in outlays. Although you are not saying you are triggering the reserve, you are using those figures. Those figures are in our budget on the basis if the reserve is triggered.

You say you are not triggering them today or you have not triggered them now. If it is not triggered, how would what you have said you can do change?

In other words, if you had to reduce that figure of $299 billion to what it would be without the reserve, the $292 billion, what would your priorities be?

Mr. TAFT. Our priorities would be the same as they are.

Senator CHILES. What would we have to give up?

Mr. TAFT. It depends on what you put in the $292 billion. We have some bills and they are different bills. The Senate Armed Services Committee has one bill that it has completed marking up at $294 billion.

The House Armed Services has marked up a bill at $292 billion. It also has a bill at $286 billion. It has two bills which it is going to be considering. This committee has not marked yet, but the House Appropriations Committee has marked, I believe, to $292 billion.

We need to work with all these committees to show them what our priorities are. What would be in the $299 billion depends on what you took out to get there from $320 billion, which we do not know yet. Each committee takes out different things to get there and then to go to $292 billion could be different things yet, or if you are going in the other direction, from $292 to $299 billion.

We cannot answer a hypothetical question about a budget that no one has made up.

Senator STEVENS. It is not hypothetical with us because we are the only committee that must comply with the budget resolution outlay targets. Neither of the authorization committees are marking outlays. The House Appropriations Committee does not pay attention to them really because a point of order does not lie against their bill as it would ours.

So, when we go to the floor we are the first committee to be subject to the point of order provisions of Gramm-Rudman.

Senator CHILES. They are proposing to mark at $282 billion, but they are not triggering the reserve.

How do we do that?

Mr. TAFT. My understanding was that you were going to mark to $292 billion. What the midsession review says is that the administration still has under consideration the option of triggering the reserve. We know how that is done. We are considering how to do it.

What we would do would require, if you passed the $292 billion budget, a submission of $7 billion supplemental. We would do that. What precise form that $7 billion supplemental would take would, of course, depend on what was in the $292 billion. Until we know that, we cannot submit it.

Senator STEVENS. We have to mark to the $279 billion level first; $292 billion, $279 billion. They do not read out. We are going to get to that in a minute.

First, let me get to Senator Proxmire.

DEFENSE PRIORITIES

Senator PROXMIRE. I was not going to follow up on this, but I cannot resist. It is so startling and shocking to me, Senator Chiles points out and you concede he is right, the $20 billion cut will result in a $100 million specific reduction which means one two-hundredths of $20 billion which, of course, means we are operating nearly in the dark. We do not know what we are doing.

Even if you work with the numbers of the committee, the committee chairman, and ranking member, most of the Congress that has the duty, consititutional authority, to determine what our defense priorities are will not know what they are doing, will not have any specific understanding.

We want to know, for instance, are you going to cut readiness, personnel, procurement? Are you going to cut R&D?

Unless we have that precise understanding of what we are doing, we are operating on the basis of permitting the Defense Department to do whatever they wish to do, which is a means of walking away from our constitutional responsibility.

NO CUTS IN PERSONNEL PROGRAMS

Mr. TAFT. Senator, I do not understand that point at all. You are doing the cutting. You are going to show us in your bill what has been cut and that is as it should be. That is your constitutional responsibility.

I do not have any quarrel with your constitutional responsibility, only with the cuts you do. I do not think there is any doubt about the administration's priorities. If you wanted to know where they were, and this has been true over the last 5 years when we have gone through these reductions, we have basically said our priorities are our people, pay for the troops, readiness, and our strategic programs.

Those have been the ones that every time people have asked us what we do not want to cut—essentially is the way it comes up to us because the Congress wants to cut—but what would you protect if we must cut, those are the things we have pointed out.

Those are the things, frankly, that the Congress has agreed with us, less on the strategic program, that has been a much more controversial subject, but on people and readiness. When the Congress has gone about cutting the budget, they have protected those. We agree with that priority.

Essentially procurement of conventional items has more than the burden and we have not disagreed with that outcome except that we do not want it at higher levels overall. As priorities within any given level, there has been a controversy about the strategic program, particularly specific aspects of it, MX and SDI, over the years, but there is no doubt about the administration's position on these things.

Senator PROXMIRE. There is a big doubt in my mind.

What you are telling me is reassuring in many ways because I am in favor of the readiness and personnel, and so forth. What we want to know is the true, painful fact of what you will cut. You will have to cut a substantial amount here.

We want to know what it is specifically. It may be procurement. We want your guidance. As you say, we have the authority; of course, we do. But you have the expertise, the knowledge, the responsibility. Unless we are told precisely where to cut, we cannot perform our duties the way we should.

Mr. TAFT. I would say to you, if you are looking for advice on that subject, look at the Armed Services Committee bill which is on the floor today. Essentially we support that in its present form.

Senator STEVENS. The authorization bill is $7 billion over outlays and $3.5 billion over budget authority. I could not get out of the Senate Appropriations door on that bill.

Mr. TAFT. The way to get it out of the Senate Appropriations Committee's door with a bill of that sort is to adopt the measures I have spoken to here which will handle that outlay problem.

INFLATION

Senator PROXMIRE. In January 1985 the administration estimated inflation would be 4.4 percent for fiscal year 1986. In February of this year you estimated inflation would be 4.1 percent for fiscal 1987.

Do you agree that both estimates were too high and that they result in excess inflation funding for the Department of Defense?

Mr. TAFT. The estimates at the time they were made were not criticized by anybody as being too high as far as I can recall. They were criticized by some people as being too low.

Experience has suggested that they were too high. As estimates made at the time, they were general consensus estimates. I believe most of the criticism was that they were too low.

Senator PROXMIRE. We all make mistakes and I know I have probably made my share. Your answer is——

Mr. TAFT. The estimates when they were made at the time were not too high. They were good normal estimates. Experience has suggested the actual inflation was below the estimate.

EXCESS INFLATION FUNDING

Senator PROXMIRE. According to your own figures, excess inflation funding has amounted to about $7 billion per year over the past 5 years.

In light of the midyear revision, how much do you estimate there will be in excess inflation funds for fiscal year 1986 and fiscal year 1987?

Mr. TAFT. I do not know the figures that would result from that, but I will say this and I think it is important because I heard your questioning of Dr. Penner, we have no particular pride in asserting one estimate over another. We think it is important for us to make at any time the best estimate of inflation that we can and we will defend it at the time we make it.

I think the committee also has a duty to estimate, and it certainly does this, inflation. Essentially what I am saying to you, Senator, is that we will tell you what the effects of any inflation estimate you wish to make will be. We will work with this committee. We will provide you those figures.

It is an open book. There is no benefit to either of us to pretend that our estimates are any better than the other's estimates and not to know the results or consequences of them and we will work with you on that.

EXCESS INFLATION FUNDS

Senator PROXMIRE. As of now, how much do you estimate you will be in excess inflation funds in fiscal years 1986 and 1987?

Mr. TAFT. They depend on your new assumptions and I do not have the precise figures. We will certainly work with the committee not only on our estimate, but if you want to make a different estimate, we will provide you the figures for that.

Senator PROXMIRE. Could you supply for the record the figures that you have as of now?

Mr. TAFT. Yes, sir; I should say we have already done this to at least the other three committees. I do not know if we have done it for this committee.

Senator PROXMIRE. Give us what you can.

Mr. TAFT. Any estimate you want to make we will provide you with the impact of that and show you exactly what happens. That is the best offer we can make.

Senator STEVENS. I thought you just took those inflation savings to the Armed Services Committee? That was the Goldwater amendment to the authorization bill.

Mr. TAFT. That was the result of working with that——

Senator STEVENS. How much did you take there already, about $6 billion?

Mr. TAFT. It was $4 to $6 billion, in that range. Those were fiscal year 1986 as well as fiscal year 1987 funds.

Senator STEVENS. I think the Senator ought to understand we have deleted substantial amounts from 1985 and prior. This is taken for 1986.

Mr. TAFT. And 1987.

Senator STEVENS. 1987 advancement, you have already calculated it for 1987?

Mr. TAFT. They have. The Senator is correct. The estimates in January, while good at the time, have turned out to be higher than experienced.

CONTROLLING INFLATION FUNDS

Senator PROXMIRE. I previously sent a draft legislative proposal to Assistant Secretary Helm for his comment on what we can get from the Defense Department on controlling inflation funds, getting better information, and so forth.

Do you have any views on the major features of the proposal?

Mr. TAFT. Senator, I have thought considerably about this problem because it has been a difficult one. Politically there has been a lot of talk about it that has not been all that focused. I think it is a complex subject, how we calculate inflation, and so forth.

My own judgment is that the best approach is for us to clearly expose to the Congress in the submission of our budget exactly what assumptions we have made and to explain clearly the implications of those assumptions in our budget request.

Then I think at a later time, 3 months if that is what the Congress wants, and that is presently the requirement, we make a reestimate, or 6 months, whatever period you want, I think you should be entitled to request it, and we will reestimate.

It is basically a mathematical exercise. I think anybody who wants to know what is going on should be permitted to know. We want to work with the committees to bring that about.

Senator PROXMIRE. I wrote this letter on July 23 to Mr. Helm. I wanted a comment on it. If you could give me a comment, I would appreciate it.

Mr. TAFT. I will be glad to.

REPROGRAMMING

Senator PROXMIRE. GAO studies show a strong pattern in the use of reprogramming. In each of the past 6 years, most reprogrammed funds have come out of procurement and gone into R&D.

How do you explain this?

Mr. TAFT. I think the explanation of the source does have largely to do with the fact that our prices for weapons have been lower than we had budgeted for and lower than the committee had budgeted for and that is why that is the source of funds that are needed for reprogramming.

Senator PROXMIRE. It may be a shift of priorities as established by the Congress? It may well be that the Congress could go along with it and you were right in putting more funds in R&D and not in procurement.

Does this not represent action on the part of the Defense Department that differs from the priorities established by the Congress?

Mr. TAFT. No, sir; in this sense. The reprogramming authority of the Department is subject to the review of four committees of Congress that appropriate the money. Every reprogramming we have comes up to this committee, sits before it. Some have been the subject of hearings, some have been the subject of hearings before other committees, and it is approved by this committee.

That is the process that the Congress has established for these reprogrammings and we follow it.

Senator PROXMIRE. That is a good point. It is a decision that has been made by custom by the committees, often by committee chairmen and ranking members, not by the Congress as a whole.

Mr. TAFT. I think the Congress has established as a whole the reprogramming format. It is prescribed in statute and we adhere to it. There is nothing devious about it. This committee sees hundreds and hundreds of reprogrammings a year and approves them or disapproves them.

BLACK PROGRAMS

Senator PROXMIRE. Is it not correct much of the reprogramming funds are either classified or black programs?

Mr. TAFT. I do not think there is a disproportionate amount in black programs of the overall budget. In fact, of the ones, and I sign them all and I am guessing, I would think fewer in black programs proportionately.

Senator PROXMIRE. Can you tell us how much has gone into black programs?

Mr. TAFT. No, sir.

Senator PROXMIRE. In your judgment, would it be appropriate for the Defense Department to change the defense priorities set by Congress through reprogramming procedures?

And if you shift billions of dollars from one category of defense to another category, is not that a change in priorities?

Mr. TAFT. Let me revise my answer to the previous question first.

The answer should have been, yes, sir, but not here. We will provide you with that information if you want, how much is in black programs. That was the wrong answer.

The other question as to the redirection, as I say, that is subject to the review of all four committees. Many of them are disapproved by these committees. I can only assume that when they are disapproved or approved that that reflects the priorities of the Congress.

Senator STEVENS. Dr. Penner, could I get you to come up to the table, too, with my friend, Mr. Taft, and his assistant?

LOW DOD INFLATION RATE

Before Senator Proxmire leaves, it is my understanding CBO takes the position that the inflation amount estimated by DOD is too low in defense; is that right?

Mr. PENNER. Right at this moment?

Senator STEVENS. For 1987. You say the inflation level estimate is too low; is that correct?

Mr. PENNER. By the numbers I gave you before, it is about $900 million excess.

Senator STEVENS. Your revised estimate said that you thought the inflation level should be 3.1 which is higher than the DOD level.

Mr. TAFT. It is higher than the inflation estimate in the administration's midyear, I believe.

Mr. PENNER. I was accumulating the inflation forecast errors in the 2 years for 1986 and 1987.

Senator STEVENS. The Armed Services Committee took $2.6 billion out of the authorization bill on the basis of advice from DOD. Those were inflation savings expected in 1987.

We look at your figures and your projections. As I see them, there is not that much inflation that can be taken out.

Am I right or wrong?

Mr. PENNER. We have a very slightly lower inflation rate—very slightly lower. We have 2.8 percent in 1986 and 3 percent in 1987, whereas the administration has 2.9 percent in 1986 and 3 percent in 1987. It is just a very tiny difference.

Senator STEVENS. Have you got 3 percent for 1987?

Mr. TAFT. The midyear is fiscal year 1987.

Mr. PENNER. We will be releasing our most recent number today.

MIDYEAR PROJECTION

Senator STEVENS. You are changing yours to 3 percent for 1987?

Mr. PENNER. That is correct.

Senator STEVENS. Are you changing yours to 3 percent?

Mr. TAFT. I believe the midyear projection is 3 percent.

Senator STEVENS. We have made great progress.

Let me say to both of you we just finished a trip out west. We went to at least three defense plants. We were very impressed with one thing. That is that we saw components being manufactured in advance of the contract requirements. Firms are producing now a portion of the items that are under contract to deliver in 1988.

We saw that the industrial sector is so well put together now that their production rates are excelling and they are very proud of it. That means, however, they are presenting to the Department of Defense bills for progress payments that by definition are increasing this outlay "bow wave."

PROGRESS PAYMENTS

We are looking at what Mr. Taft said about the concept of progress payments. We have had some discussions with your people, Dr. Penner, about progress payments. We believe that declining interest rates and lower inflation should force us to reevaluate the percentage of the progress payments.

ESTIMATE FROM INSPECTOR GENERAL

We have an estimate from the inspector general of the Department of Defense that lowering the rate from 90 to 80 percent produced a savings of $2.1 billion. They claim it is already a savings in 1985 of $2.1 billion.

Mr. TAFT. That was going from 90 to 80 percent, which we did do.

Senator STEVENS. I would like to know if there is some way we can get you all together now to estimate the savings from lowering the rate further to 70 percent. We can agree on the inflation figure. Maybe we can agree on what a further reduction in progress payments would do, with very low interest rates, low inflation.

Progress payments should not be that high technically when the items will not be delivered for 2 more years. If you could give us an update in terms of actual experience now based on the inspector general's report of savings on the first 10 percent reduction, if we came down another 10 percent, at least we ought to get an equivalent savings.

You know, that $2 billion outlay margin means a tremendous amount to us because, obviously, we will mark to the $279 billion outlay target.

Can you get together and give us a review of that?

Mr. PENNER. Yes, sir; I think there have already been discussions on that. These discussions are ongoing, so we are still working on it. According to our latest information, a 10-percentage-point reduction in the progress payment rate would save $1 billion, which is the number I believe Secretary Taft also used in his testimony.

IG REPORT

Senator STEVENS. The inspector general had given us a report that says the 10-percent reduction in 1985 actually resulted in a $2.1 billion reduction. If we come down 10 percent further, why do we only get $1 billion on a 10-percent reduction when $2 billion is the estimated savings from the 10-percent reduction implemented last year?

That is the IG assessment. Have you seen this report of theirs?

Mr. PENNER. We have just gotten information on it. We would like to discuss it with them further to get the details underlying that estimate.

Mr. TAFT. Mr. Chairman, we will be very glad to work with the CBO. We think that really all of the points that I raised in my testimony will reduce outlays. We would like to explain to them exactly why that is and we would, for heaven's sake, like them to score it, which I gather is your problem, as exactly as we have put it out and as we persuade them it should be.

Senator STEVENS. I agree with you on the concept of progress payments.

I am not sure I can agree on the Prompt Payment Act delay. The Prompt Payment Act was enacted to ensure that the Government pays its bills when they are actually due. Delaying payments is like your concept of paying service people 1 day late and taking credit for savings. It just pushes everything out in front of us. We will catch up with that someday. I do not see that.

I do see the progress payment reduction as a substantive policy change and hope we can get together.

Let me go to two more things now. I want to get back to the question I asked before I left. Let me just take three items in the accounts before us.

VARYING OUTLAY RATES

National Board for Promotion of Rifle Practice, CBO rates that in outlays as 97 percent. DOD says it is 79.5 percent. The difference is 17.5 percent.

Stock funds in the bills before us, CBO rates the outlay at 77 percent—in the first year I am talking about—DOD rates it at 28 percent, a difference of 49 percent. That is $1.5 to $2 billion we are talking about.

On the Marine Corps O&M CBO rates it at 81 percent; DOD, 69 percent.

These are just significant differences in the way you are rating specific accounts based upon, I believe, the same historical approach. This is what is giving this committee fits.

The good news, Dr. Penner, at 77 percent on our stock funds means if we reduce stock funds, I get 77 cents of outlay savings to the dollar cut in budget authority.

The bad news is when we appropriate the funds, it is rated by defense at only 28 cents on the dollar.

So that we really have to cut other things out to have the equivalency as far as the budget authority level. Somehow or other I would like to see us have a committee between the two of you, and, incidentally, Mr. Taft, the reason OMB is not sitting beside you is the OMB Director, Mr. Miller, told me you speak for the administration on this issue.

Mr. TAFT. I understand. He told me the same thing.

Senator STEVENS. You have one number and it is your number from now on.

Mr. TAFT. Very good.

Senator STEVENS. OMB claims that the defense numbers have been worked out in the midyear review. We are back in sync. We have one administration spokesman, that is you. That means we only have two people in this game right now—you and Dr. Penner.

Since you are the people who are going to score the numbers under the new Gramm-Rudman-Hollings approach, that is one good thing. I want you to develop a team for us that will go through these things with the accountants.

If one sits in one office and one sits in another office, we end up by trying to figure out who do we agree with. We cannot go forword with a bill until we get some unanimity in terms of outlays. It is not budget authority with this committee; it is outlay target that will be difficult.

That is not too much to ask, is it, Dr. Penner, to see how closely we can come to eliminating some of these differences?

Mr. PENNER. We are always willing to discuss these things. We are always willing to subject outlay estimates to outside scrutiny.

ATTEMPTED AGREEMENT ON OUTLAY FIGURES

Senator STEVENS. I am asking if you cannot get together in terms of trying to be accurate and see how closely we can come to agreeing on outlay figures before we mark up.

Mr. PENNER. I have to be very candid with you. If we have a difference as big as we did last February, it is very, very difficult to resolve that big a difference. When the differences are much smaller and are within the range of estimating error, then presumably discussions can help a lot.

Senator STEVENS. We cannot mark up a bill if the differences between OMB and DOD outlay rates are akin to the 77 percent and 28 percent dealing with stock funds. There is no way we can come through with it. We must have some way to negotiate the outlay rates between the two of you now.

I really think that it has to be done. DOD is relying on some people and CBO is relying on other people. Neither making a final judgment for consistency. The basic factors in the judgment of the individual assistants in CBO and DOD are not the same. I do not know whether it is computer runs or what it is, but we have to resolve this.

If there is a difference of 5, 10, 15 percent, that range can be accommodated. You cannot accommodate a 49-percent difference in an item as important as the stock fund.

Mr. TAFT. Mr. Chairman, and for our side, for myself, we will certainly do this. I would like to have on the table an agreement with the CBO, on the implications for outlays, just to price them.

Maybe the committee will not want to do them, maybe it will, but you ought to know how much you will get for each one of these items I testified to that we can do. Most of them we can do, ourselves.

MARGINS OF ERROR

Senator STEVENS. Those are pickups. Once we get to the problem of defining what the difference is—they are important—it is not as important as getting some unanimity. This difference of 49 percent in dealing with these accounts demonstrates to me the fuzziness of estimates, to begin with, and the impact of the differences on this bill.

I believe that there ought to be some way to get together, which gets me back to my original question to you, Dr. Penner. You can see now why I am disturbed about the $50 million margin of error that we are allowed when we produce a bill, yet you acknowledge a margin of error

in CBO estimates of $2 to $5 billion. That's important since CBO estimates the outlays of our bill. If the bill exceeds the outlay targets of the budget resolution, a point of order lies against the bill.

How can this committee live with a $50 million margin of error when you live with a $2 to $5 billion margin of error?

Mr. PENNER. That is a problem that permeated the budget process from the beginning. The whole process is structured to depend on very precise forecasts and other technical estimates. It depends on a precision that far exceeds anybody's ability to forecast. Moreover, the Balanced Budget Act has made the situation even worse, as you indicated in your opening statement.

Senator STEVENS. GRH permits a $10 billion margin before sequester.

ADVANCE NUMBERS

Mr. PENNER. They do not, not really. When it comes to the crunch next October, we will have to make a point estimate and if that point estimate indicates that the deficit is $153.9 billion, there would not be a sequestration.

If it indicates it will be $154.1 billion, there will be a sequestration, even though we know that around that point estimate typical errors could be $20 billion.

The process depends on what I was going to call a science, but is actually a set of procedures that just do not deliver the accuracy that you need.

The solution to this problem, to the extent that one exists, is to try the best we can, as Secretary Taft just suggested with his particular proposal, to give you a number in advance. Both of us know that that may not turn out to be a right number, but it establishes the rules of the game. It establishes the dimension of the playing field within which you have to operate.

The sooner we can establish those estimates—and I think we have been doing a little better recently than we have in the past—the better off it is for you. In essence, the budget process fixes the rules very precisely at the beginning, even though we all know it is not going to turn out that way.

The problems that we have result, frankly, when you present us with extraordinarily complicated reprogrammings. As you say, these are sometimes the result of compromises made late at night, and so on, but they are very difficult for us.

The earlier we know what you are doing so that we can deal with you as to what language actually appears in the bill and how we interpret it, the better off we will all be. That is exactly what we are trying to work on very hard with your staff.

Senator STEVENS. I hear you, but you know when we get in conference, I need a schedule that states the outlay rates agreed upon for the accounts between Defense and CBO. If you can agree to such a schedule we are not going to have headaches and late-night problems because we will look at that table and we will say to the House, "If you increase that by so much, this is what it is going to cost in outlays."

We do not have that schedule. The House is using DOD percentages. We are using CBO percentages. We have used CBO primarily in this subcommittee and they have used DOD. As a consequence, we end up coming out of conference with a blend of two. They get their way on some, we get our way on some, but the differences are as they view them in final readout.

I want to reiterate, when we get to the floor, a point of order will lie against the bill, if we are in excess of outlay ceiling. Defense will be part of a continuing resolution or omnibus appropriations bill, in my opinion.

AGREED TO OUTLAYS

I believe we ought to have a schedule of outlays that is agreed to in principle, not in terms of any particular amount, but just looking at the account and saying if you put money in the National Board for Rifle Practice, we agree it is 82 percent, or whatever it is, that is what the outlay figure will be.

I do not know why that is too much to request. We finally had to work it out with the House in terms of using the same computer, as I said before. All I am asking you two is to find out some way to load the computer you can rely on in terms of outlay so that when you press the button, you will get the same result as far as the item is concerned.

I plead with you to do it. There is no way to make sense out of it now with Gramm-Rudman-Hollings unless we can get some understanding of what the estimate is going to be by everybody as applied to any particular account. I do not think it is too simplistic.

Incidentally, if you do not do it, I am going to put it in the law. I am going to say this account must be read out at an outlay figure of *x* percent, every blasted one of them. Let someone face it on the floor. We can no longer go through this thing and having different estimates come out of different computers at the last minute.

We lost $3.5 billion in defense last year because of that problem that developed on the House floor. At the last minute, because of this problem, they said we were not right about the estimates that we had used. We came back and lost $3.5 billion.

I think that was a total miscarriage of the legislative process.

PRODUCTION TOOLING

One last thing now and that is this. DOD funds significant amounts for production tooling which, in our opinion, could and should be funded with contractor equity or with borrowed capital. Northrop, when they built the F–20 used corporate funds for their tooling and for production equipment.

On the C–17, $182 million of the request before us now for 1987 is for plans and tooling costs. We probably are going to lose the C–17 if that remains the same.

I would like to know why could we not adopt a policy of requiring production tooling from equity or capital of the contractor with the exception of acceptance testing equipment. I believe that is already being

implemented to a certain extent by the Navy, and if we did, we adopted that in this bill, the question is will you read it out the right way?

Will you give us credit for that if we say this production tooling must be put up by the contractor by equity or borrowed capital?

Mr. PENNER. I have not confronted this issue before, sir. I will be glad to give you an answer for the record.

Senator STEVENS. I would appreciate it if you would.

[The information follows:]

PRODUCTION TOOLING AND TEST EQUIPMENT

The Department of Defense has tentatively identified about $561 million in the request for 1987 associated with production tooling and test equipment. CBO does not know how much of the funding would outlay in the first year, but CBO believes that it is reasonable to assume that there would be some outlays. Consequently, a policy of requiring production tooling to be financed by equity or capital of defense contractors would yield immediate outlay savings.

The amount of funding is uncertain for three reasons. First, the DOD estimate of $561 million does not include inputs from Air Force procurement commands. Second, we do not know yet how much is in the budget for production tooling and how much is for test equipment that, by assumption, would be exempt from the new policy. Third, some of the proposed funding for production tooling may be for the Government's own use in depots or other facilities that also would be exempt.

Given the uncertainties about the funding and outlay rate, CBO cannot estimate the outlay savings at this time, but it will continue to work with the DOD on developing an estimate.

CAPITAL CONTRIBUTIONS FROM CONTRACTORS

Senator STEVENS. I think you ought to consider that, Mr. Secretary. As we see it, the one way to get these items into production is to require that there be a greater capital contribution from the contractors involved up front. They will get a return on that capital in the end result.

Mr. TAFT. Mr. Chairman, we have been, as you said, doing that in a number of contracts and with good results. We have been aware, however, that each contract is a little different. You bargain about a lot of different things, including this one.

What we have tried to do is to give our contracting officers the flexibility to get the best overall contract and many of them this is the way to go.

The Navy has tended to think that. They have been trying. We are looking very hard to see their results an how well they are doing. I think they are doing well, they like it. But some of the other services on some of the other contracts have had different experiences and the Navy, itself, has on occasion not done that.

Where we do do it I am absolutely persuaded that it has an effect on the outlays and that outlay effect should be taken into account. There is no question about that.

Senator STEVENS. No one is kidding anybody. If you require the contractor to put it up front, they will get it back in the end. There is another bow wave, but they get it in terms of investment rather than in terms of Government payment up front.

I think this position we are in right now, if that is read out properly, I think we can show that it will be helpful. There is no use in our doing it if it is not going to result in an outlay reduction that we anticipate.

Let me ask one last question.

PROMPT PAYMENT INITIATIVE

Do you have any comment about Secretary Taft's prompt payment initiative in terms of outlay reduction? Have you studied that, Mr. Penner?

Mr. PENNER. We have not studied it in detail. We would like to get together with them and find out the basis for the estimate.

Senator STEVENS. Could you give us a report on that?

I assume there is an agreement that there is some reduction in outlays from progress payment reductions. We are not in agreement on how much.

Mr. PENNER. We have not discussed it with them in detail.

Senator STEVENS. I would like to see if we can get agreement on progress payment outlay reduction, on the prompt payment outlay reduction, on the capital construction cost requirement, capital cost requirement for the contractors I outlined, and some attempt to bring together the readout on accounts without regard to how much is in them.

If it is possible to get an agreed statement of outlay impact for accounts and come closer to that, then I think a lot of our problems will be over this year. Even if you were within 10 percent, we can still ride that one through, but I do not think we can do it when it is as great as 49 percent difference.

INITIATIVES TO MEET OUTLAY PROBLEMS

Mr. O'Keefe suggests maybe the way to do this would be to ask you if you could have your people score Secretary Taft's suggestions to us of the initiatives that DOD has suggested to meet the outlay problems, initiatives that we could pursue.

One of them is prompt payment. The other is progress payments and there is a third one that I forget.

If you could do that for the record?

Mr. PENNER. There are two issues to which we will be glad to respond. The first is how much are they worth? The second is what do you put in the language so that they are actually done and somebody is responsible for it.

Senator STEVENS. I would invite that. I think Secretary Taft should also, because if we can get some unanimity in approach, I think we would be better off.

[The information follows:]

Rudolph G. Penner
Director

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

August 19, 1986

Honorable Ted Stevens
Chairman
Subcommittee on Defense
Committee on Appropriations
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

At the August 7 hearing, the Congressional Budget Office (CBO) was asked to attempt a reconciliation with the Department of Defense (DoD) on outlay rates and to estimate the outlay impact of Secretary Taft's proposals. We have begun a fruitful dialogue with the DoD on outlay rates, but I must make two important points regarding scoring for your 1987 bill. First, CBO scores outlays consistent with the budget resolution as interpreted by the Budget Committees which have already instructed us as to what outlay rates to use--those consistent with the average account-level rates in our reestimate of the President's request. Second, if we were to use DoD's rates, we would have to change outlays from prior as well as new budget authority and the net result looks like we would have to raise total outlays.

With respect to Secretary Taft's proposals, we are in substantial agreement with the DoD on their outlay impact. The proposals should be carefully specified in bill language making it clear whether progress payment rates to small businesses are being changed and where payment rates for shipbuilding and military construction are to be similarly reduced.

DOD AND CBO DISCUSSION OF OUTLAY RATES

As I noted in my testimony and in our Analysis of the President's Budgetary Proposals (February 1986, see pages 28-29 and 142-143), CBO and DoD do not have much disagreement on what historical outlay rates are--only if they are still relevant. Consequently, the reconciliation of rates is easy in theory.

What makes the reconciliation difficult in practice is that it involves total reestimates of outlays--current and prior. For example, if CBO adopted the DoD first-year outlay rate for the stock funds it would adopt the second, third, and later year rates as well; because stock fund budget authority has been falling, DoD's higher rates after the first year would lead CBO to raise outlays from prior by more than it would lower outlays from new budget authority--for a net increase of over $250 million.

Institutional constraints are also important. The Budget Committees of both the House and Senate have directed CBO to use the average rate for each account in CBO's reestimate of the President's February request. We have done so in estimating outlays for the authorization bills of each Armed

Services Committee and for regular appropriation bills reported or passed so far (including all five regular bills affecting defense in the House and three of five in the Senate). We could not change our rates for your bill without explicit instructions from the Budget Committees to do so. Also, I doubt the Administration wants to change its rate structure because doing so would mean raising its estimates another $6-7 billion after raising them about $9 billion in the Mid-Session Review less than two weeks ago.

I should add that through July, DoD outlays have totaled $220.5 billion, continuing a rate of growth that will push outlays higher than even our lastest estimates. A rate change at this point would have to take account of the most recent data.

OUTLAY IMPACTS OF LEGISLATIVE PROPOSALS

As you know, the Budget Committees have the final say on what is scoreable and what is not, but I am including our estimates of outlay savings for 1987 based on what I believe DoD intended. Also, I think it is important to state the general principles that are important for language to have a scoreable impact.

1. The language must specify what is to be done and must not be diluted by leaving discretion to anybody in the Executive Branch.

2. The language must give the authority to take the action if it does not already exist--no later legislation or committee approval can be required.

3. Somebody has to be held accountable for seeing that the actions are taken.

I would be happy to review specific language at any time to see if, in our judgment, the relevant criteria have been met.

Progress Payment Rate-- The proposal would reduce the progress payment rate for big business by 10 percentage points and lower 1987 outlays by $950 million. This estimate assumes that legislative language makes the change applicable to shipbuilding and military construction; otherwise, the savings are about $190 million less. Extending the change to small businesses raises the savings to $1,150 million with the same caveat on shipbuilding and construction, but the caveat would be worth more--about $230 million.

Payment Delays-- The proposal would delay progress payments by ten days and would delay payments governed by the Prompt Payment Act ten days into the grace period allowed by the act. The progress payment delay saves $1,800 million in 1987 and the other delay saves an additional $3,550 million.

Forbid Early Deliveries-- The proposal would forbid the DoD from accepting delivery before a contracted date. The provision would save about $500 million.

Delay Military Payday by One Day-- The proposal would push outlays that would have occurred in 1987 into 1988, in 1988 into 1989, and so forth. In 1987, the language would lower defense outlays by $4,406 million, but because of foregone receipts in the military retirement trust fund ($1,549 million) and foregone revenues ($808 million) the net budget savings would only be $2,049 million. Language that avoided the revenue loss would lower defense savings to $3,598 million and language keeping the trust fund

payment in 1987 would lower defense savings to $2,857 million. If both the trust fund payment and the revenues were kept in 1987, then defense saving would be $2,049 million which is the net budget impact under any scenario.

Contractor Financed Tooling— The Department of Defense has tentatively identified about $561 million in the request for 1987 associated with production tooling and test equipment. CBO does not know how much of the funding would outlay in the first year, but CBO believes that it is reasonable to assume that there would be some outlays. Consequently, a policy of requiring production tooling to be financed by equity or capital of defense contractors would yield immediate outlay savings.

The amount of funding is uncertain for three reasons. First, the DoD estimate of $561 million does not include inputs from Air Force procurement commands. Second, we do not know yet how much is in the budget for production tooling and how much is for test equipment that, by assumption, would be exempt from the new policy. Third, some of the proposed funding for production tooling may be for the government's own use in depots or other facilities that also would be exempt.

Given the uncertainties about the funding and outlay rate, CBO cannot estimate the outlay savings at this time, but it will continue to work with the DoD on developing an estimate.

With best wishes,

Sincerely,

Rudolph G. Penner

cc: Honorable Mark O. Hatfield
Chairman, Committee on Appropriations

Honorable John C. Stennis
Ranking Minority Member

Honorable Pete V. Domenici
Chairman, Committee on the Budget

Honorable Lawton Chiles
Ranking Minority Member

DIFFERENCES AT READOUT

Senator STEVENS. Mr. Secretary, I am going to lean on you to notify us if you and Mr. Penner have any differences on what we say we are going to do in terms of readout.

We are going to assume there is none in view of the fact OMB asked not to be called because they were stating, and I want to put on the record, that you are the administration's spokesman in terms of this outlay problem.

Mr. TAFT. That is correct. I talked with Mr. Miller yesterday. As I say, he told me the same thing. We will speak for them.

Senator STEVENS. I thank you. You may think we are belaboring it, but I think we are going to save everybody some late-night agony if we can get an initial agreement going in on the outlay figure. I am really not talking to you about budget authority at all.

The priorities they are asking us to make, we can make those, but we have to know what they mean in terms of outlays when we make them or we are not going to get by the floor.

SUBMITTED QUESTIONS

The committee has additional questions which we will submit to DOD for their response. They will be inserted in the record at this point.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

ADDITIONAL COMMITTEE QUESTIONS

SAC Hearing on DoD Expenditure Rates with DepSecDef-8/7/86

Question 1: Mr. Secretary, the mid session review by OMB was completed yesterday. Can you tell us what you projected for FY 1986 defense outlays with the President's budget in February and what you are now forecasting?

Answer: The FY 1987 President's budget estimated defense outlays for FY 1986 at $258.4 billion. We are now forecasting, based on the mid session review, $263.5 billion.

Question 2: Can you explain why outlays are $5.6 billion higher than you anticipated?

Answer: The $5.6 billion increase represents function 050, national defense, which includes some outlays from the Energy Department. The increase that pertains to function 051, Department of Defense, Military, is $5.1 billion.

Outlay estimating is an imprecise process which utilizes both historical data and judgmental determinations by management reflecting a number of considerations and assumptions.

Historically, estimates are within 2 percent deviation. The increase of $5.1 billion in the mid session represents only a 1.97 percent deviation from plan.

Question 3: Are you readjusting outlay projections for FY 1987 in conjunction with the August 15 OMB and CBO report on the deficit.

Answer: No. There is no basis to do so at this time.

Question 4: Over the past five years have you ever estimated defense outlays within $50M of the actual spending that occurred?

Answer: In FY 1982, the plan for defense outlays was $182,800 million. Actuals were $182,850 million, a difference of +$50 million.

Question 5: Secretary Weinberger testified to this subcommittee that he could manage outlays to live within budgeted totals or Congressional imposed constraints. It appears from your statement that you agree with his assessment.

Can you explain the policy adjustments you would institute to meet the outlay targets included in the budget resolution?

Answer: Each of the legislative provisions which would assist the DoD in meeting the outlay targets contained in the Budget Resolution were presented in Secretary Taft's testimony. Backup rationale and dollar impact estimates have been provided to the Subcommittee staff.

Inflation Savings

QUESTION 6: Inflation has become a controversial issue of late. There have been reports by CBO and GAO discussing huge windfalls. Mr. Secretary, are you familiar with this controversy and what is your portion on the $20-$30B inflation windfall?

ANSWER: The allegations that defense is getting funds via overestimation of inflation that Congress did not intend is simply not the case.

The Department reports to the Congress on specific aspects of budgeting for inflation and prepares regular estimates of funds available for obligation which may not be needed for their original purpose. Our records show that lower inflation, after the budgets were submitted to the Congress, provided $28.4 billion for FY 1982 through FY 1985, and an additional $7.5 billion for FY 1986, accounting for a total of $35.9 billion. These funds were: (1) applied to other defense requirements through congressionally approved reprograming procedures; (2) reduced by the Congress as a part of defense program cuts; or (3) lapsed. This was all reported to the Congress and described in detail on several occasions. Also reports are prepared on a recurring basis under section 1407 of the FY 1986 DoD Authorization Act that identify any change in requirements due to changing rates of inflation.

QUESTION 7: Do you think Congress should establish a new procedure to calculate inflation?

ANSWER: No. The Congress has ample visibility concerning the status of the funds it authorizes and appropriates for defense. We provide regular reports, as noted in the previous question, regarding inflation and funds related to more accurate economic assumptions.

We have demonstrated the validity of our process of budgeting and reporting inflation in very clear terms. After years of experience without adequately budgeting for inflation, I believe that the current system best serves the requirements of the Congress, the needs of the DoD, and the interests of the American people. It would indeed not be wise to revert to some system of budgeting for inflation that leads to the problems that were experienced in the previous decade.

DEFENSE FINANCIAL AND INVESTMENT REVIEW

Question. Secretary Taft, you recently signed out the instructions implementing last year's Defense Financial and Investment Review -- so-called DFAIR Study. Would you briefly summarize the results of that study and your direction to the Department?

Answer. The Defense Financial and Investment Review (DFAIR) project contained several reforms for better integrating the Department's contract financing and profit policies. Right now, our policies are not fully responsive to changes in the economic environment. We intend to overhaul completely the way contracting officers determine prenegotiation profit objectives or mark-up on defense contracts. This not only involves greatly simplifying the method we now use but also introducing other key factors such as the extent of financing we provide on defense contracts. DFAIR recommended reducing the amount of mark-up currently awarded to contractor indirect costs. DFAIR also recommended more differential in the mark-up awarded for capital assets employed. Right now, we give the same mark-up for land as we do manufacturing equipment. A Joint Service group is developing a proposed new policy. The new policy has a target implementation date of January 1, 1987.

Question. Secretary Taft, the DFAIR Study found that we're paying ½ to 1 percent higher profits than the objective calls for. Have you quantified how much the increase in profit objective has added to this year's budget request?

Answer. The DFAIR Study did not find that we were actually paying ½ to 1 percent higher profits. The DFAIR Study indicated that the contracting officer's prenegotiation profit objectives were ½ to 1 percent higher than expected as a result of the profit policy changes made in Defense Acquisition Circular 76-23. The prenegotiation profit objectives do not represent negotiated profits or even realized profits. While there is certainly a relationship between the prenegotiation profit objective, negotiated profit, and realized profit, the DFAIR study did not conclude that overall contract prices were ½ to 1 percent higher. The DFAIR study also recognized many other factors that impact on contract price. For example, the April 1985 reduction in the customary progress payment rates from 90% to 80% would have had an effect because it increased financing costs to be funded from contractor sources.

Question. Do you agree with the GAO estimate of $1.4 billion?

Answer. No. We disagree with the conceptual basis of GAO's argument, since it does not consider the impact of our not adopting DFAIR's alternative recommendations either to raise the customary progress payment rate from 80% to 85%, or to raise prenegotiation profit objectives .5 percent if the customary progress payment rate was kept at 80%. GAO is focusing only on the need to rescind our current profit policy, which we have already decided to do, and not on the interrelationships between profit and financing.

Even if GAO is conceptually correct, the dollar impact is significantly overstated. This is because the number of contracts which used the Weighted Guidelines Method were far less than the

number GAO used to determine the $1.4 billion impact. The Weighted Guidelines Method is required on negotiated contract actions exceeding $100,000, although it can be waived on actions that are less than $500,000 or meet other exempting criteria. GAO would have to assume over $100 billion of contracts used the Weighted Guidelines Method to have a $1.4 billion impact. Including shipbuilding, the amounts actually reflected in the DD Form 1499 (Report of Individual Contract Profit Plan) as having used Weighted Guidelines for the years 1981 to 1983 were as follows:

1981	$13.4 billion
1982	$24.2 billion
1983	$35.6 billion

Question. Is it likely that we're paying $600 to $700 million more due to this policy?

Answer. No. First, even without considering the impact of reduced contract financing being provided to the contractor, GAO's estimates are significantly overstated. The reduction in the customary progress payment rate from 90% to 80% in April 1985 and our decision to neither raise the rate to 85% or compensate contractors for leaving it at 80% offset the unintended increase in prenegoation profit objectives. It must also be stressed that we are aggressively pursuing reforms to our profit policies.

Question. I'm advised that you intend to change the current policy effective January 1, 1987. When the new policy becomes effective, how much will defense costs be reduced?

Answer. The reforms will affect many areas of defense costs. First, the policy changes should reduce prenegotiation profit objectives by roughly 1 percentage point. Based on the dollars which used the Weighted Guidelines Method in 1983 ($35.6 billion), the potential reduction would be approximately $350 million. There are other considerations that would affect this amount. The new policy will link profit and contract financing. To the extent that the prime interest rate continues to drop, contract length can be shortened, and increased emphasis can be placed on capital investment, profits would be reduced further.

Question. I understand that the Department has taken exception to the recommendation of GAO, Government Affairs and Government Operations Committee to revert, on an interim basis, to the profit policy developed in 1976. I believe it is referred to as DPC 76-3. What's your response to those suggestions.?

Answer. We agree that the current policy under Defense Acquisition Circular 76-23 should be rescinded and have already taken steps to do so. The problem arises in issuing a replacement policy so that contracting officers can continue to use the Weighted Guidelines Method, its related forms, and its related reporting systems. Simply replacing the current policy by reissuing an old policy that had existed under DPC 76-3 does not realistically solve this problem. GAO's perception that this would be a simple fix is wrong. The Federal rule-making processes would still have to be followed. Furthermore, contracting officers, price analysts, and auditors who have entered the contracting field since 1980 would all have to be trained. Our

view is that, if the policy is to be rescinded, it should be replaced with a policy that contains meaningful reforms and not the old one.

We can appreciate the need to do something now, but we believe that for reasons already discussed, interim actions already taken by the Department are adequate. We will, however, continue to look at our approach and take additional action if necessary.

Question. Last year the reduction in progress payments was justified on the basis of lower interest rates which have gone down even more since then. Beyond that, the DFAIR discussion of the unintended increase in profit objective, there is no mention of progress payments in the calculations. Aren't you saying that changes in progress payments effect "realized profit" rather than profit objective, which is sort of an apples and oranges comparison?

Answer. No. As urged by the President's Private Sector Survey on Cost Control (known as the "Grace Commission"), the DFAIR report is based on the interrelationships between progress payments and profit. Our reformed profit policy will explicitly show these interrelationships by automatically adjusting prenegotiation profit objectives based on decreases or increases in financing variables such as interest rates, progress payment rates, and length of contract.

It must also be stressed that there were considerations on profit and progress payments that were not discussed directly in the DFAIR report. When the DFAIR recommendations were presented, two alternatives were considered dealing with progress payments. First, because interest rates had not fallen enough, DFAIR recommended raising the customary progress payment rate from 80% to 85%. Second, if the customary progress payment rate was left at 80%, DFAIR indicated that prenegotiation profit objectives should be raised .5%. We opted for leaving the customary progress payment rate at 80% and not raising prenegotiation profit objectives.

As an interim action, our not providing an additional .5% in the prenegotiation profit objective for an 80% customary progress payment rate had an offsetting impact to leaving the current profit policy in place while we developed a new one.

Question: Secretary Taft, since April of last year when you reduced progress payments 10 percent, interest rates have continued to decline.

Your prepared statement indicates that another 10 percent reduction in progress payments is now justified but that it will generate only a billion dollars in outlay savings in the first year.

In 1985 your IG estimated outlay savings for a similiar reduction to be worth $2.1 billion in the first year. Why is your estimate so different?

Answer: The IG's outlay savings report was based on projected outlays and the assumption that 85 percent of the projected outlays were related to progress payments. Subsequent to that

report, the DD 350 contract information system was revised to require the reporting of actual contract financing. The billion dollar outlay estimate is based on FY 1985 data reported in the DD 350 system as representing actual financing information adjusted for subsequent budget authority changes.

GOLDWATER PROPOSAL PRECLUDING SEPTEMBER CONTRACT PAYMENTS

Question. The Senate Armed Services Committee is considering a proposal to prohibit issuing contract payment checks during each Septemer in 1987, 1988, 1989 and 1990, except for small business. What do you think of this proposal?

Answer. We are already implementing a policy which delays invoice payment to the later of 30 days after receipt of invoice or 30 days after Government acceptance of goods and services. We would caution use of additional payment measures in view of the requirements of the Prompt Payment Act.

PRODUCTION TOOLING

Question. Mr. Secretary, why shouldn't the Department adopt a policy where each contractor is required to provide all production tooling except for the test equipment used for government acceptance testing?

Answer. The Navy is testing this policy on a few programs. We will evaluate the results of those tests and then make a decision if this should be a DoD-wide policy.

Question. Isn't this policy being implemented for Navy contracts?

Answer. Yes, on some programs.

Question. What would be the impact of adopting such a policy in FY 1987 for all defense contracts?

Answer. We cannot estimate the impact without first evaluating the experience of those cases now underway.

FY 1987 Inflation Savings

QUESTION 20: Mr. Secretary, I understand that the Department has reestimated its funding requirements for inflation. Some of the reestimate has been calculated into the Senate Authorization Bill.

What is the Department's current estimate of the inflation savings for FY 1987?

ANSWER: The recent update of the President's budget does contain revised inflation and fuel assumptions received from the

OMB as part of the Mid-Session review. Use of these revised rates reduce previously estimated appropriations in the form of unobligated balances and there is an impact in FY 1987. The total impact is $6.4 billion. These amounts are based on projections and, therefore, will accrue only to the extent that these new inflation rate projections prove accurate.

QUESTION 21: What economic assumptions are being used to support this reestimate?

ANSWER: These savings are consistent with the economic assumptions in the Mid-Sesssion review of the FY 1987 budget and reflect a rate of 2.7 percent in FY 1986, compared to the original assumption of 4.1 percent for major systems and 3.2 percent for GNP, and 2.9 percent in FY 1987 compared to the original estimate of 4.1 percent.

QUESTION 22: What adjustments should be made to prior year programs?

ANSWER: Our most recent estimate as reported under Section 1407 of the FY 1986 Defense Authorization Act identified prior year savings of $2.3 billion.

QUESTION 23: Does the FY 1987 adjustment include the 30 percent premium "kicker" that has been reported as being left erroneously in the estimate for the out year spending?

ANSWER: The budget submitted by the President in February of this year reflected the same inflation rate for all programs, i.e., both for major systems and for all other purchases. These savings do not reflect any adjustment for an additional premium for major weapon systems because no such factor was included in the FY 1987 budget for the years FY 1987 and beyond.

CONCLUSION OF HEARING

Senator STEVENS. Thank you very much, gentlemen.

The hearing will conclude, and the subcommittee stands in recess subject to the call of the Chair.

[Whereupon, at 11:55 a.m., Thursday, August 7, the hearing was concluded and the subcommittee was recessed to reconvene at the call of the Chair.]

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